# 2003

# HSBC Bank Canada

*Annual Report and Accounts*

HSBC

The world's local bank

## Corporate Profile

*HSBC Bank Canada, a subsidiary of HSBC Holdings plc, has more than 160 offices. With over 9,500 offices in 79 countries and territories and assets of US$1,034 billion at 31 December 2003, the HSBC Group is one of the world's largest banking and financial services organizations.*

## Shareholder Information

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**STOCK EXCHANGE LISTINGS**

HSBC Bank Canada Class 1
Preferred Shares Series A
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HSBC Canada Asset Trust
Securities Series 2010 (HSBC HaTS™)
(HBH.M-TSX)

**TRANSFER AGENT AND REGISTRAR**

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**SHAREHOLDER CONTACT**

For change of address, shareholders are requested to write to our transfer agent, Computershare Investor Services Inc., at their mailing address.

Other shareholder inquiries may be directed to our Shareholder Relations Department by writing to:

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## Contents

## Message from the President and Chief Executive Officer

HSBC Bank Canada faced many challenges over the past year. Some, such as changes in interest rate spreads and foreign exchange, are part of the business of banking. However, unexpected events like SARS, a massive power outage in Ontario and the East coast of the United States, and forest fires in British Columbia, made 2003 unusually challenging in many respects.

Despite these negative events and uncertainty in the global economy, 2003 was a successful year for HSBC Bank Canada. The bank saw solid balance sheet growth in mortgages, personal loans, cash management and commercial deposits and a decline in provisions for credit losses. Assets under management, our retail brokerage business and HSBC InvestDirect (formerly Merrill Lynch HSBC) were positively impacted by increased retail investor activity following a recovery of the North American equity markets in 2003.

A large part of that success is due to consistent delivery of our promise of superior customer service. We were pleased to see this recognized in an independent survey of small and medium-size enterprise owners published by the Canadian Federation of Independent Business in October. HSBC was ranked first among major chartered banks in overall satisfaction among business clients and had the highest customer retention rate.

Also in 2003, we continued to build on our successes as "The world's local bank" by providing our customers with the benefits of our international connections. The HSBC Group launched HSBC *Premier* International Services in eight countries, including Canada. The new service offers a portable credit rating, free Internet wire transfers, and personal relationship managers at home and abroad, for customers with personal banking needs in more than one country. We also opened three new HSBC *Premier* Centres and two new branches in Canada to better serve our clients.

After the completion of the acquisition of Household International by HSBC Holdings plc in the first quarter, HSBC Bank Canada began working with Household in Canada to develop synergies so that we may better serve our combined customer base in Canada and reach new customers.

HSBC Bank Canada has grown tremendously from our birth in 1981 with only one office. Our many successes have enabled us to support numerous community initiatives across the country. Whether it is the Great Canadian Geography Challenge, the HSBC Celebration of Light or a smaller initiative such as the Niagara Region Children's Safety Village, HSBC is dedicated to maintaining a positive presence across Canada. It is our way of expressing our thanks to the communities in which HSBC Bank Canada has had the privilege of operating over the years.

Our success over the past year is attributable to an outstanding group of employees working as a dedicated and enthusiastic team. With their continuing efforts, we will continue to grow HSBC's business in Canada during the coming year, providing excellent service to our existing customers, attracting new customers, and contributing positively to the communities where we do business.

Lindsay Gordon

Lindsay Gordon
*President and Chief Executive Officer*

# Management's Discussion and Analysis

*For the year ended December 31, 2003*

## Five-Year Financial Summary

| | Years Ended December 31 | | | | |
|---|---|---|---|---|---|
| | **2003** | 2002 | 2001 | 2000 | 1999 |
| **Statements of income** | | | | | |
| Net interest income | **$ 867** | $ 856 | $ 754 | $ 666 | $ 540 |
| Other income | **463** | 441 | 419 | 462 | 384 |
| Total revenues | **1,330** | 1,297 | 1,173 | 1,128 | 924 |
| Provision for credit losses | **61** | 127 | 92 | 39 | 43 |
| Net interest and other income | **1,269** | 1,170 | 1,081 | 1,089 | 881 |
| Non-interest expenses: | | | | | |
| Salaries and employee benefits | **388** | 339 | 359 | 385 | 339 |
| Premises and equipment(1) | **109** | 107 | 115 | 108 | 101 |
| Other(2) | **267** | 284 | 230 | 249 | 197 |
| Total non-interest expenses | **764** | 730 | 704 | 742 | 637 |
| Income before taxes | **505** | 440 | 377 | 347 | 244 |
| Provision for income taxes | **189** | 164 | 147 | 155 | 79 |
| Non-controlling interest in income of trust | **16** | 16 | 16 | 8 | – |
| Net income | **300** | 260 | 214 | 184 | 165 |
| Preferred share dividends | **8** | 8 | 8 | 15 | – |
| Net income attributable to common shares | **$ 292** | $ 252 | $ 206 | $ 169 | $ 165 |
| Basic earnings per common share ($) | **0.62** | 0.55 | 0.45 | 0.52 | 0.59 |
| Cash dividends per share ($) | | | | | |
| Class 1 Preferred Shares Series A | **1.56** | 1.56 | 0.80 | n/a | n/a |
| Class 2 Preferred Shares Series A | **n/a** | n/a | 1.02 | n/a | n/a |
| Common | **0.32** | 0.44 | – | 2.13 | – |
| **Balance sheet highlights** | | | | | |
| Total assets | **$ 37,509** | $ 35,189 | $ 33,260 | $ 29,438 | $ 25,051 |
| Total loans | **24,933** | 23,869 | 21,870 | 19,753 | 17,130 |
| Business and government loans | **11,664** | 11,949 | 11,575 | 11,330 | 9,634 |
| Residential mortgage loans | **10,880** | 9,809 | 8,377 | 6,809 | 5,769 |
| Total deposits | **29,339** | 28,372 | 26,707 | 23,511 | 20,170 |
| Personal deposits | **13,924** | 14,432 | 13,390 | 12,116 | 10,858 |
| Subordinated debentures | **504** | 528 | 447 | 422 | 392 |
| Shareholders' equity | **1,819** | 1,673 | 1,612 | 1,406 | 1,252 |
| **Risk-based capital ratios (%)** | | | | | |
| Tier 1 Capital | **8.4** | 8.4 | 8.6 | 8.6 | 7.9 |
| Total Capital | **11.1** | 11.4 | 11.3 | 11.5 | 10.9 |
| **Financial ratios (%)** | | | | | |
| Return on average common equity | **18.7** | 16.4 | 14.9 | 15.3 | 18.4 |
| Return on average total assets | **0.80** | 0.72 | 0.65 | 0.60 | 0.63 |
| Net interest margin | **2.66** | 2.79 | 2.70 | 2.68 | 2.32 |
| Other income percentage(3) | **34.8** | 34.0 | 35.7 | 41.0 | 41.6 |
| Cost:income ratio(4) | **57.4** | 56.4 | 60.0 | 65.8 | 68.8 |
| **Funds under management** | **$ 14,323** | $ 11,888 | $ 9,559 | $ 9,209 | $ 9,633 |
| **Custodial accounts** | **4,409** | 3,208 | 2,686 | 2,854 | 3,060 |
| **Total assets under administration** | **$ 18,732** | $ 15,096 | $ 12,245 | $ 12,063 | $ 12,693 |

(1) *Premises and equipment expenses includes amortization.*
(2) *Other expenses in 2002 includes a $30 million restructuring charge.*
(3) *Other income percentage is other income as a percentage of total revenues.*
(4) *Cost:income ratio is total non-interest expenses as a percentage of total revenues.*

Management's discussion and analysis is dated February 19, 2004, the date that our consolidated financial statements for the year ended December 31, 2003 were approved by the Board of Directors of HSBC Bank Canada.

*Basis of preparation of financial information.* We prepare our consolidated financial statements in accordance with Canadian generally accepted accounting principles. The financial information included in management's discussion and analysis which, unless otherwise stated is either at December 31, or for the years then ended. It is derived either directly from our consolidated financial statements or from the information we have used to prepare them. Unless otherwise stated, all references to $ means Canadian dollars. All tabular amounts are in millions of dollars except where stated. Certain financial information we are required to disclose as part of management's discussion and analysis is included in the table on page 2.

*Other available information.* We file all of our news releases, annual and quarterly consolidated financial statements and shareholder reports, including our Annual Information Form, with SEDAR. Copies of these documents can be obtained from SEDAR's website: sedar.com.

*Outstanding share data.* Note 11 to our consolidated financial statements contains details of the number of preferred and common shares issued and outstanding at December 31, 2003. Subsequent to that date, there have been no share issues.

*Forward looking financial information.* This document contains forward-looking statements, including statements regarding the business and anticipated financial performance of HSBC Bank Canada. These statements are subject to a number of risks and uncertainties that may cause actual results to differ materially from those contemplated by the forward-looking statements. Some of the factors that could cause such differences include legislative or regulatory developments, technological change, global capital market activity, changes in government monetary and economic policies, changes in prevailing interest rates, inflation levels and general economic conditions in geographic areas where HSBC Bank Canada operates. Canada is an extremely competitive banking environment and pressures on rates and our overall margin may arise from actions taken by individual banks acting alone. The continuing risks and uncertainties could provide testing economic circumstances throughout 2004, particularly if Canadian and US government monetary policy puts downward pressure on interest rates. Varying economic conditions may also affect equity and foreign exchange markets which could also have an impact on our revenues. The factors disclosed above may not be complete and there could be other uncertainties and potential risks factors not considered here which may impact our results and financial condition.

## Overview

We are the largest full-service, internationally owned and seventh largest bank overall in Canada; operating in every region, with total assets of $38 billion as at December 31, 2003.

Originally established in 1981 with our head office located in Vancouver, British Columbia, we have grown, mainly by acquiring new customers resulting from our reputation for providing superior customer service, and through strategic acquisitions, to become a fully integrated financial services organization. With more than 160 offices across Canada, we provide personal and commercial banking services, corporate, investment banking and market services, online and full-service brokerage, investment management, personal trust services and direct sale of home, auto and travel insurance.

## The HSBC Group

We are a member of the HSBC Group, whose parent company HSBC Holdings plc ("HSBC Holdings") is headquartered in London, England. Our clients have access to the HSBC Group, "The world's local bank", one of the largest banking and financial services organizations in the world. The HSBC Group's international network comprises over 9,500 offices in 79 countries and territories in Europe, the Asia-Pacific region, the Americas, the Middle East and Africa. With listings on the London, Hong Kong, New York, Paris and Bermuda stock exchanges, shares in HSBC Holdings are held by around 200,000 shareholders in some 100 countries and territories. The shares are traded in New York in the form of American Depositary Receipts. At December 31, 2003 HSBC Holdings' market capitalization was US$172 billion.

# Management's Discussion and Analysis (continued)

Through an international network linked by advanced technology, including a rapidly growing e-commerce capability, the HSBC Group provides a comprehensive range of financial services: personal financial services; consumer finance; commercial banking; corporate, investment banking and markets; and private banking.

Complete financial and operational information in respect of HSBC Holdings and the HSBC Group can be obtained from its website: hsbc.com, including copies of HSBC Holdings' plc 2003 Annual Review and its 2003 Annual Report and Accounts.

## Our Business Focus

### Strategy

Our objective is to be the leading international provider of financial services in Canada with a significant presence in identified key markets.

In 2000, we introduced a strategic plan entitled "Managing for Value" designed to support the HSBC Group's key strategic initiatives. In November 2003, the HSBC Group announced a new strategic plan entitled "Managing for Growth." The vision of the HSBC Group remains unchanged but the focus will be on building the international franchise. We will support this strategy by expanding and building on our strengths as a provider of financial services to small and midsize companies as well as personal financial services to individuals. The provision of corporate commercial financial services, including trade finance, treasury and merger and acquisition ("M&A") advisory services to large HSBC Group customers continues to be a focus. To achieve these objectives, we utilize the global capabilities of the HSBC Group to provide our customers with excellent service. Our strategy has the following key operating components:

- **Leverage the global strength and reach of the "HSBC" brand to expand our customer base and geographic presence** – HSBC is now considered one of the world's 50 most valuable brands. We believe the global strength and reach of the "HSBC" brand is our most significant competitive advantage. We intend to continue to build Canadian awareness of the HSBC Group's North American Free Trade Agreement ("NAFTA") and international capabilities to enhance our market share and realize economies of scale in Canada. While our strategy is focused principally on organic growth, it also allows for opportunistic acquisitions.

- **Deepen existing client relationships** – We are focused on increasing penetration of our customer base by better understanding and meeting clients' needs and ensuring they have ready access to the full range of our products and services and the NAFTA and global capabilities of the HSBC Group.

- **Re-engineering organizational processes and structures to optimize efficiency, while enhancing sales and advisory activities** – We will implement a variety of strategies, which will promote operating efficiency by supporting an increased focus by our branch staff on sales and relationship management. This will mean reallocating resources to ensure they are deployed so as to maximize our sales potential.

- **Ensuring systems development, capacity and performance continue to address the changing and growing needs of our clients** – We will take full advantage of our HSBC Group connections by leveraging the HSBC Group's technology investments as we build and enhance our systems.

- **Enhance multi-channel delivery systems** – We are focused on improving customer service by providing increased choice for delivering services through a variety of channels. While our branch network will remain a critical delivery channel, we plan to expand the market for Telephone and Internet Banking. We are also implementing a focused e-business strategy to enhance electronic delivery capabilities.

- **Attract, retain and motivate a high performance team of employees** – This strategy has been critical to our success and the development of a strong sales and service culture throughout the organization.

## Customer groups

We offer a wide range of products and services to targeted segments of the financial services market, through three major customer groups, Personal Financial Services, Commercial Banking and Corporate, Investment Banking and Markets. The organization and structure of our operations focus on customer needs, and are uniquely integrated across service and product lines, subsidiaries, strategic alliances and internationally through the HSBC Group's worldwide network.

- **Personal Financial Services ("PFS")** provides our personal customers in Canada and around the world, where appropriate, with excellent customer service and offers access to a comprehensive range of financial products and services through a variety of delivery channels.
- **Commercial Banking ("CMB")** provides a complete range of financial products and services to Canadian commercial clients through our branch network and subsidiary offices in Canada as well as through other HSBC Group offices around the world.
- **Corporate, Investment Banking and Markets ("CIBM")** provides a comprehensive range of financial services to an international group of our large multinational clients as well as client sales, service and distribution, balance sheet management and proprietary trading.

In March 2003, the HSBC Group completed its acquisition of Household International ("Household") announced in 2002. Household's operations include 109 offices located across Canada. We are working in partnership with Household in Canada to develop products and provide services to best meet customers' needs for both Household and HSBC in Canada.

## Highlights for 2003

- We were rated the highest for overall quality of customer service to the small and medium size enterprise market amongst all major chartered banks included in 'Banking on Competition: Results of CFIB Banking Survey.' This is an independent survey of SME owners conducted by the Canadian Federation of Independent Business ("CFIB") and was published in October 2003.
- We started joint initiatives with Household Canada to lay the groundwork for growing the HSBC Group's Canadian consumer finance business.
- We successfully introduced Business Internet Banking with registrations reaching a penetration rate of 14%, surpassing targeted numbers. In addition, the penetration rate for Personal Internet Banking grew to 28% compared to 14% in 2002.
- We continued to build awareness of the HSBC brand through a number of significant sponsorships, including the HSBC Group's Formula One Jaguar racing sponsorship at the Canadian Grand Prix in Montreal, the 'HSBC Stars on Ice' figure skating tour in Canada and the 'HSBC Celebration of Light' international fireworks competition in Vancouver.
- We introduced initiatives to upgrade and grow the sales force in retail brokerage which helped drive growth in brokerage funds under management by 36% over 2002.
- We re-branded our direct brokerage operation, Merrill Lynch HSBC as HSBC InvestDirect Inc. prior to becoming a division of HSBC Securities (Canada) Inc., thereby completing the re-integration of our direct investing channel into HSBC. An increase in the number of accounts helped brokerage funds under management increase 23% over 2002.
- We increased the number of customer contacts and cross-sales as we completed the successful roll out of *client*CONNECT, our integrated customer relationship management system, to all branches.
- We expanded the reach of HSBC *Premier* with a 87% increase in customers in 2003. In addition, we launched HSBC *Premier* International Services, a new service offered by HSBC worldwide to support customers moving to a new country.
- We continued to exploit the competitive advantage of being a member of the HSBC Group in our Trade Services business. We have the largest market share in Canada for Import Documentary Credits ("DCs") and we rank second in Canada in terms of combined Import/Export DCs.
- We launched the Group's E-treasury foreign exchange solution to our customers enabling them to trade on-line.

# Management's Discussion and Analysis (continued)

## Outlook for 2004

In 2004, we will continue to focus on growing our core businesses. We expect the acquisition of Household by the HSBC Group will be a competitive advantage and allow us to build our consumer finance and other retail business across our customer groups through cross referrals and a number of other joint business initiatives.

2003 was a challenging economic year in Canada with the impact of SARS and BSE ("Mad Cow" disease) as well as the effects of forest fires in British Columbia and the power outage in Ontario. In addition, the extremely competitive environment for residential mortgages and deposits impacted our overall margin. This requires us to enter the year with a continued emphasis on controlling costs while retaining the flexibility to take advantage of opportunities to grow as they arise.

A summary of our goals for 2004 is:

- **Managing for growth** – We aim to grow revenues and drive sales by focusing on customer acquisition and cross sell, utilizing the full benefits of a recently implemented Customer Relationship Management System (*client*CONNECT). We will exploit our strengths such as cross border capabilities, high service culture and trade services, and focus on key segments such as HSBC *Premier* and mid-market commercial. We will continue to focus on NAFTA cross-border business by positioning ourselves as the leading cross-border bank. In addition, we will focus on increasing market share in our retail securities business and implement a new sales management model which integrates the sale of Trust and Investment services. We will simplify the sales management infrastructure and implement a new benchmarking system to drive results.
- **Proactively reallocate resources** – We will aggressively reallocate resources to areas of higher economic value and long term growth while implementing initiatives that lead to further operational synergies. Resources will be channeled to fund a moderate growth in branches and expansion of retail securities and our CIBM business.
- **Free up time for customer sales and service** – We will continue to streamline processes through re-engineering initiatives. We aim to maximize financial benefits of North American alignment and strategic investments such as call centres, e-Commerce and customer service and data centres. We also expect to continue to use Group I.T. solutions wherever possible.
- **Realize synergies with Household** – We will share a common business focus, particularly maximizing relationships with existing customers and leveraging HSBC Group capabilities that should enable us to add shareholder value. We plan to significantly expand the Auto Finance business through our relationship with Household in Canada. We are also working with Household to implement a cross referral initiative, particularly for mortgages and personal loans. We are in a position to leverage Household's expertise in I.T. and credit scoring.
- **Focus on risk management** – We will invest in new systems and processes to improve our risk management capabilities and to ensure we are compliant with updated corporate governance and Basel II Capital Accord requirements.

## Analysis of Financial Results for 2003

### Highlights

- Net income was $300 million for the year ended December 31, 2003, an increase of 15.4% over the same period in 2002.
- Return on average common equity was 18.7% for the year ended December 31, 2003 compared to 16.4% in 2002.
- The cost:income ratio was 57.4% for the year ended December 31, 2003 compared to 56.4% in 2002.
- The provision for credit losses decreased to $61 million for the year ended December 31, 2003 compared to $127 million in 2002.
- Total assets were $37.5 billion at December 31, 2003 compared to $35.2 billion at December 31, 2002.
- Total assets under administration were $18.7 billion at December 31, 2003 an increase of 24.1% compared to 2002.

*Revenues and net income:* We earned total revenues, consisting of net interest income and other income, of $1,330 million compared to $1,297 million in 2002. Net income for the year ended December 31, 2003 was $300 million, compared with $260 million in 2002. Basic earnings per common share were $0.62 compared with $0.55 in 2002.

We acquired HSBC InvestDirect Inc. ("HIDC"), formerly known as Merrill Lynch HSBC Canada Inc., on October 31, 2002. For financial reporting purposes, the income and expenses of HIDC in 2002 were accounted for effective July 1, 2002, the date HSBC Group acquired full ownership of HIDC.

*Net interest income:* For the year ended December 31, 2003, we recorded net interest income of $867 million, an increase of $11 million, or 1.3%, from $856 million in 2002. We benefited from strong consumer spending and an active housing market, driven primarily from record low interest rates throughout 2003. Although average interest earning assets increased to $32.5 billion in 2003 from $30.6 billion in 2002 our net interest margin, as a percentage of average interest earning assets, fell to 2.66% in 2003 from 2.79% in 2002. The net interest margin was impacted during 2003 by the competitive environment for residential mortgages and personal deposits, with the latter resulting in an adverse change in funding mix towards higher cost wholesale deposits. Some of our business customers opted for financing through bankers' acceptances, which led to a reduction in the total interest we earned on higher yielding commercial loans.

*Other income:* We earned $463 million in other income, an increase of $22 million, or 5.0%, compared to $441 million in 2002. Our fees from capital market activities were higher than 2002 due to increased retail trading commissions, resulting from the strengthening equity markets since the first quarter of 2003, and higher corporate advisory fees. Retail trading commissions from HIDC were $22 million for the whole of 2003 compared with $6 million for six months in 2002. These were partially offset by lower institutional trading revenue following restructuring of our institutional equity sales and trading business in 2002. Credit fees for 2003 were higher than 2002 resulting from increased volumes in bankers' acceptances arising from our customers' propensity for shorter-term funding. Revenues from our foreign exchange activities in 2003 benefited from the increased volatility due to the continued strengthening of the Canadian dollar relative to the US dollar. Income from our securitization activities was higher in 2003 due to selling and administering larger volumes of loans. In 2002, we realized $17 million on the sale of our shares in the Toronto Stock Exchange.

*Non-interest expenses:* Non-interest expenses were $764 million in 2003, an increase of $34 million, or 4.7% from $730 million in 2002.

Salaries and benefits in 2003 were higher compared with 2002. The largest increase was due to increased performance-based compensation as capital market fees and net income were higher in 2003 compared with the prior year. To further improve our overall efficiency, we recorded a charge in the fourth quarter to reduce headcount by approximately one per cent. Salaries and benefits from HIDC were $8 million for the whole of 2003 compared with $3 million for six months in 2002. Ongoing employee benefits costs, particularly medical costs, were higher in 2003 compared with 2002. Beginning in 2003, we applied the fair value method of accounting for stock-based compensation and recorded an expense of $4 million for the year ended December 31, 2003 for grants to employees in 2003 of HSBC Holdings stock options.

Premises and equipment expenses for 2003 were comparable with those in 2002. Rationalization of leased office space at the end of 2002 resulted in a lower rent expense for 2003. These savings were offset by increased charges during 2003 related to improving delivery channels and the infrastructure of our computer networks.

Other non-interest expenses increased by 5.1% in 2003 compared with 2002. Other non-interest expenses from HIDC were $14 million in 2003 compared with $6 million for six months in 2002. In the latter part of 2003 we experienced higher operating costs associated with increased business volumes, particularly related to retail equity trading. To increase their size and scope, we also made a higher investment in our wealth management businesses. In 2002, non-interest expenses included higher marketing costs and a charge for rationalization of leased office space. In 2002, we also recorded a charge of $30 million associated with a restructuring of our institutional equity sales, trading and research business.

## Management's Discussion and Analysis (continued)

*Provision for income taxes:* Our effective income tax rate for 2003 and 2002 was 38.7%. Lower levels of tax-exempt income and the non-deductibility of stock-based compensation negatively impacted the rate in 2003. However, this was partially offset by a reduction in the charge for future income taxes. This was due to recognizing an increased benefit in the value of future income tax assets, resulting from the Province of Ontario announcing higher corporate income tax rates for future years.

*Credit quality and provision for credit losses:* We benefited from a strong risk management process and a stable credit environment during the year. The provision for credit losses was $61 million compared with $127 million in 2002. Specific provisions decreased to $37 million in 2003 compared with $135 million in 2002, which reflected the impact of an exposure within the Canadian telecommunications sector.

Total impaired loans fell to $203 million at the end of 2003 compared with $225 million at December 31, 2002. Total impaired loans, net of specific allowances for credit losses, were $148 million at December 31, 2003 compared with $145 million at December 31, 2002. During 2003, we added $27 million to our general provisions to increase the general allowance for credit losses to $258 million or 107 basis points of risk weighted assets compared with $231 million or 102 basis points at the end of 2002.

*Balance sheet:* Total assets at December 31, 2003 grew to $37.5 billion, up $2.3 billion from $35.2 billion at December 31, 2002. Low interest rates during 2003 increased our customers' demand for residential mortgages and consumer loans which together increased $1.3 billion, although this was offset somewhat by securitizations. Bankers' acceptances increased by $0.9 billion, more than offsetting the $0.3 billion decrease in loans to our business and institutional customers.

Total deposits were $29.3 billion at December 31, 2003, $0.9 billion higher than $28.4 billion at the end of the previous year. Personal deposits were $0.5 billion, or 3.5% lower, due to the strengthening of the Canadian dollar relative to the US dollar in 2003. However, using constant exchange rates, personal deposits at December 31, 2003 were $0.3 billion, or 1.8%, higher than at the same time in 2002.

Subordinated debentures decreased from $528 million at the end of 2002 to $504 million at the end of 2003, due to the impact of the weaker US dollar relative to the Canadian dollar on our US dollar denominated debenture.

*Total assets under administration:* We increased funds under management to $14.3 billion at December 31, 2003 compared with $11.9 billion at December 31, 2002. The growth was due to increased retail investor activity following a recovery of North American equity markets in 2003. However, the strong Canadian dollar relative to the US dollar offset some of the overall growth.

*Capital ratios:* Our Tier 1 capital ratio was 8.4% and the total capital ratio was 11.1% at December 31, 2003. This compares with 8.4% and 11.4%, respectively, at December 31, 2002.

*Dividends:* During 2003, we paid regular quarterly dividends of 39.0625 cents per share on our Class 1 Preferred Shares – Series A resulting in a total annual dividend of $1.5625 per share totalling $8 million. We paid dividends of 31.8358 cents per common share totalling $150 million.

## Condensed Quarterly Summary of Statements of Income

| | 2003 | | | | 2002 | | | |
|---|---|---|---|---|---|---|---|---|
| | *Quarter ended* | | | | *Quarter ended* | | | |
| | *Dec. 31* | *Sept. 30* | *June 30* | *March 31* | *Dec. 31* | *Sept. 30* | *June 30* | *March 31* |
| Net interest income | **$ 214** | **$ 213** | **$ 222** | **$ 218** | $ 210 | $ 222 | $ 213 | $ 211 |
| Other income | **120** | **127** | **111** | **105** | 123 | 105 | 103 | 110 |
| Total revenues | **334** | **340** | **333** | **323** | 333 | 327 | 316 | 321 |
| Provision for credit losses | **(8)** | **(14)** | **(19)** | **(20)** | (25) | (34) | (43) | (25) |
| Net interest and other income | **326** | **326** | **314** | **303** | 308 | 293 | 273 | 296 |
| Non-interest expenses | **(207)** | **(188)** | **(190)** | **(179)** | (191) | (165) | (205) | (169) |
| Income before taxes | **119** | **138** | **124** | **124** | 117 | 128 | 68 | 127 |
| Provision for income taxes | **(42)** | **(53)** | **(47)** | **(47)** | (48) | (46) | (23) | (47) |
| Non-controlling interest in income of trust | **(4)** | **(4)** | **(4)** | **(4)** | (4) | (4) | (4) | (4) |
| Net income | **73** | **81** | **73** | **73** | 65 | 78 | 41 | 76 |
| Preferred share dividends | **(2)** | **(2)** | **(2)** | **(2)** | (2) | (2) | (2) | (2) |
| Net income attributable to common shares | **$ 71** | **$ 79** | **$ 71** | **$ 71** | $ 63 | $ 76 | $ 39 | $ 74 |
| Basic earnings per share ($) | **0.15** | **0.17** | **0.15** | **0.15** | 0.14 | 0.17 | 0.09 | 0.16 |

We consider that the unaudited quarterly information shown above contains all adjustments necessary for a fair presentation of such information. All such adjustments are of a normal and recurring nature.

Although our business is not seasonal, certain trends developed during 2003 which have impacted results. Although loans increased over the course of 2003, there has been a contraction in margins resulting in a stable amount of net interest income. The recovery of capital markets during 2003 resulted in other income increasing during the year. Our loan portfolio performed strongly during 2003 reflecting improved economic conditions leading to a reduction in quarterly provisions for credit losses. All other fluctuations were due to individual transactions, more details of which can be obtained from our quarterly press releases and shareholders reports which can be downloaded either from our website: hsbc.ca, or from SEDAR's website: sedar.com.

## Impact of Estimates, Judgement Issues and Selection of Accounting Policies on Financial Statements

Inherent in the preparation of financial statements is the use of estimates. We make estimates, particularly concerning the valuation of assets, allowances for impaired loans and credit losses and the estimation of liabilities and provisions, which could affect amounts reported as net income in our consolidated financial statements.

We set out details of how we apply certain accounting policies in note 1 to our consolidated financial statements. The following discussion sets out areas where we believe the selection and application of our accounting policies and the use of estimates and the application of judgement, could have a material impact on our reported results. We believe that our estimates are appropriate in the circumstances where applied.

# Management's Discussion and Analysis (continued)

## Accounting for credit losses and estimation of general allowances

We report loans as the amount advanced less an allowance for credit losses. Assessing the adequacy of the allowance for credit losses is inherently subjective, as it requires making estimates including the amount and timing of expected future cash flows that may be susceptible to significant change.

We maintain specific allowances for loans that are currently impaired. We also record a general allowance for those loans that may be impaired but have not yet been identified as so. The impaired loans and allowances section on page 22 of management's discussion and analysis provides further details in respect of the calculation of our general allowance.

## Accounting for employee future benefits

As part of employee compensation, we provide employees with pension and other post-retirement benefits, such as extended healthcare, to be paid after employees retire. In certain cases, the amount of the final benefit may not be determined until some years into the future, particularly for defined benefit pensions, where the payment is based on a proportion of final salary and upon years of service. Although we contribute to several pension plans to provide for employee entitlements, the actual amount of assets required depends upon a variety of factors such as the investment return of the plan assets, the rate of employee pay raises and the number of years over which the ultimate pension is to be paid.

After consultation with our actuaries, we make certain assumptions regarding the long term rate of investment return on pension plan assets, the discount rate applied to accrued benefit obligations, rates of future compensation increases and trends in health care costs. The assumptions we use are set out in note 13 to the consolidated financial statements. The most significant impact is a change in the discount rate applied to accrued benefit obligations. Under current accounting standards, the discount rate to be applied is a long term bond rate rather than the estimated future performance of plan assets. This rate has decreased recently resulting in a considerable increase in the amount that must be set aside to cover the obligations. In addition, in recent years, equity investments of the plans have been negatively impacted by weak equity markets. This has caused a reduction in the expected long term rate of return on plan assets, which resulted in an increase in pension expense. In addition, the impact of the loss in the current value of the plans' assets will require additional funding in the future to cover the shortfall, and we have recently contributed $26 million to our plans. In October 2003, we established a new defined contribution pension plan, which is expected to gradually decrease the future volatility of the charge for pension expense in our consolidated income statement.

Due to the long-term nature of the contribution and payment periods, changes in long-term rates could have a material impact on our reported financial results. In note 13 to our consolidated financial statements, we include an analysis of the sensitivity of the assumptions on our benefit expense.

## Income and other taxes

In establishing both the tax provision and the amount of the future income tax asset recorded in our consolidated financial statements, we make estimates of the expected rates at which our income will be taxed in a variety of jurisdictions in Canada as well as expectations regarding dates of reversals of future timing differences. If the actual amounts differ from the estimates or our interpretations of the tax legislation differ from those of the federal and provincial tax authorities, adjustments may be necessary.

## Goodwill and intangible assets

Annually, we review goodwill for impairment to assess whether its carrying value is in excess of fair value. We also regularly assess intangible assets to ensure that recoverable amounts are in excess of the book value. In determining fair value of goodwill and intangible assets, we use a variety of factors such as market comparisons, discount rates, price/earnings ratios and income estimates. The determination of values requires management judgment in the assumptions used as well as an appropriate method for determination of fair value. Any impairment in goodwill or intangible assets is charged to the consolidated income statement.

## Stock-based compensation

During 2003, new accounting standards relating to stock-based compensation and other stock-based payments were issued requiring all listed companies to adopt, from 2004 onwards, the fair value method for all stock-based compensation. We have chosen to early adopt certain transitional arrangements which allow us to record a charge on a prospective basis in respect of awards of HSBC Holdings stock options granted to employees from 2003 onwards.

Although employees are granted options for shares of our ultimate parent HSBC Holdings, no payment is made to HSBC Holdings for these options and consequently there is no impact on our net financial position.

Further details on stock-based compensation are set out in note 12 to our consolidated financial statements.

## Off-balance sheet arrangements

As part of normal banking operations, we enter into a number of financial transactions, which have a financial impact, but are not recorded on our consolidated balance sheet. These are considered off-balance sheet arrangements. These types of arrangements are contingent and may not necessarily, but in certain circumstances could, involve us incurring a liability in excess of amounts recorded on our consolidated balance sheet. These include guarantees and letters of credit, derivative financial instruments and securitizations.

## Guarantees and letters of credit

As part of our normal banking operations, we routinely issue guarantees and letters of credit on behalf of our customers to meet their banking needs. Letters of credit are often used as part of the payment and documentation process in international trade arrangements. Guarantees are often provided on behalf of customers' contractual obligations, particularly providing credit facilities for customers' overseas trading transactions and in construction financings. Guarantees and letters of credit are considered contingent obligations and are not included in our consolidated financial statements as there are no actual advances of funds. Any payments actually made under these obligations would be recorded as a loan to our customers. For credit risk management purposes, we consider guarantees and letters of credit as part of our clients' credit facilities, which are subject to appropriate risk management procedures. Letters of credit and guarantees are considered part of our overall credit exposure as set out in the analysis of our loan portfolio on pages 20 and 21, and as set out in note 15 to our consolidated financial statements.

## Derivative financial instruments

As part of our overall risk management strategy, we enter into a variety of derivatives to manage or reduce our risks in certain areas.

Derivatives include forward foreign exchange transactions where we agree to exchange foreign currencies with our counter-parties at a fixed rate on a future date. Interest rate swaps are agreements to exchange cash flows of differing characteristics (e.g. fixed rate for a floating rate based on an underlying reference rate or index) based on a notional principal amount outstanding for a fixed period in the future.

We use derivatives to limit our exposure to interest rate risk on loans and deposits with differing maturity dates, or foreign currency assets and liabilities of differing amounts. Mismatches in currency or maturity dates could expose us to significant financial risks if there are adverse changes in interest rates or foreign exchange rates.

The key issue for derivatives is not the notional amount of the derivatives, but the replacement cost of any instrument if the market value of the underlying reference rate or index has changed.

Information on our use of derivative instruments is set out in note 17 to the consolidated financial statements. The use of derivatives is subject to strict monitoring and appropriate internal control procedures to ensure no unauthorized transactions are entered into. Our accounting policies on the use of derivatives are set out in note 1 to our consolidated financial statements.

## Management's Discussion and Analysis (continued)

As set out in note 1, effective January 1, 2004, we adopted CICA Accounting Guideline 13 *Hedging Relationships*. Although the underlying accounting requirements relating to hedged items are not changed, much stricter criteria must be met for financial instruments to qualify for hedge accounting. We have changed our hedging strategy and processes to ensure those derivative transactions, which we believe best meet our hedging needs, meet the new requirements to qualify for hedge accounting.

Also set out in note 1 there are details related to new proposals relating to financial instruments, although they have yet to be finalized. Accordingly, it is not yet possible to determine the precise impact of the anticipated adoption in 2006. These proposals are expected to impact how we record assets and liabilities and income and expenses related to these instruments. This may introduce a degree of inter-period volatility on the Bank's net income resulting from marking to market derivatives that would no longer qualify for hedge accounting treatment.

### Securitizations

As part of our liquidity, funding and capital management processes we pool loans, including residential mortgages, automobile loans and personal lines of credit and transfer security interests in these loans to unrelated third parties. These securitizations, which are governed by purchase and sale contracts, are generally conducted through Variable Interest Entities ("VIEs"), financed by investors either as commercial paper or a form of longer term investment.

Securitizations allow us to transfer customer loans to a VIE and remove them from the balance sheet. However we retain the excess spread, being the interest and fees collected from our customers exceeding the return paid to investors in the VIE. We generally retain the responsibility for servicing the underlying loans as they are sold on a fully serviced basis.

In almost all securitizations, some form of credit enhancement is provided. In some cases, residential mortgages securitized are insured by either the Canada Mortgage and Housing Corporation or GE Capital Mortgage Insurance Canada, and no credit enhancement is required. In other securitizations, we agree to cover any deficiencies in cash flows up to a pre-determined amount, generally known as first loss protection. Normally the amount of the first loss protection is in excess of the amount of expected credit losses and we are required to hold these amounts in segregated cash deposits.

Accounting policies for securitizations are set out in note 1 to the financial statements. If the accounting requirements for sales treatment are met, we recognize in income, at the time of the transaction, the present value of the excess spread we expect to earn over the life of the transaction, net of any expected credit losses. This requires us to make assumptions regarding the expected prepayment rates of the loans securitized as well as the amount of credit losses. To the extent that we experience higher credit losses or loans repay at faster rates than our estimates, adjustments may be necessary. We review the carrying value of the retained interests recorded within the consolidated financial statements for impairment quarterly.

Our obligation to cover first loss in excess of these expected credit losses are not provided for in the balance sheet. Information on our securitizations, including our assumptions regarding repayment rates and expected credit losses and the maximum obligations under first loss protection provisions, is set out in note 3 to the financial statements.

### Variable interest entities

An accounting guideline has been issued which would require us to consolidate certain VIEs that do not meet specified exemption criteria. We would be required to consolidate VIEs based upon either holding a majority of the voting rights or being deemed as the VIE's primary beneficiary. It is anticipated that this guideline will be amended so as to harmonize with an amended standard recently issued by the United States Financial Accounting Standards Board, and will become effective January 1, 2005. We have not yet determined the impact of this guideline, but based on a preliminary assessment, it is not expected to have a material impact on our consolidated financial statements.

### Valuation of assets and liabilities including financial instruments

During the normal course of our business, we make extensive use of financial instruments, including funding loans, purchasing investments and accepting deposits at market rates prevailing at the time the assets were purchased or the deposits accepted.

The valuation of assets or liabilities is dependent upon the original purpose of the transaction. Where we enter into transactions with the intention of resale for trading purposes they are included in our trading portfolio or trading book. We revalue this portfolio daily and this is recorded at the market or fair value, sometimes known as marked to market. We record gains or losses in our income statement as trading income arising from the changes in our balance sheet valuation.

Assets purchased and liabilities accepted for long term investment purposes are included in our investment or banking portfolio. We record instruments in this portfolio at cost or amortized cost and interest income or expense or investment income is recorded on an accrual basis. Assets are not revalued to reflect changes in interest and or market rates, as the expectation is we will hold them to maturity, and the recorded value of the asset will be realized in the normal course of our business. If, however, there has been a decrease in the value of an asset included in the banking book other than on a temporary basis, we will establish a provision in accordance with our accounting policies.

Depending on the nature of the instrument, the recorded values of banking book assets or liabilities may be different to the fair values. Information on the fair value of assets and liabilities is set out in note 16 to the consolidated financial statements.

## Capital Management

We manage our capital resources to ensure their efficient use in the generation of shareholder value while supporting business activities, including the asset base and risk positions, as well as providing prudent depositor security and complying with all applicable regulatory requirements.

Capital adequacy for Canadian federally incorporated financial institutions is regulated by the Superintendent of Financial Institutions Canada (the “Superintendent”). Guidelines issued by the Superintendent’s office are based upon recommendations for capital adequacy standards currently provided by the Bank for International Settlements (“BIS”). Although the BIS continues to recommend financial institutions maintain 4% and 8% Tier 1 and total capital ratios, respectively, the Superintendent recommends Canadian banks maintain minimum Tier 1 and total capital ratios of 7% and 10%, respectively.

The BIS is in the process of developing new standards for capital adequacy in the Basel II capital adequacy framework expected to be in place by the end of 2006. This new framework will have a significant impact on banks as it requires capital to be held covering operational risk and market risk, not just credit risk. In addition, the calculation of risk-weighted assets will be considerably more complex than the current framework. The HSBC Group is developing a number of systems and tools in preparation for the introduction of Basel II, some of which are included with information related to credit risk on page 20.

Tier 1 capital is the permanent capital of a bank, comprising common shareholders’ equity, qualifying non-cumulative preferred shares, contributed surplus and retained earnings. Tier 2 capital includes subordinated debentures, general allowances and cumulative preferred shares. Total capital comprises both Tier 1 and Tier 2 capital. Our Tier 1 capital ratio was 8.4% and the total capital ratio was 11.1% at December 31, 2003. This compares with 8.4% and 11.4%, respectively, at December 31, 2002.

The Canada Deposit Insurance Corporation (“CDIC”) has a tiered, differential insurance premium ratings system, which includes targets for capital adequacy. One of the measures CDIC uses in determining whether a financial institution is well capitalized is an assets to regulatory capital multiple as defined by CDIC. CDIC regards a financial institution as being well capitalized if it maintains an assets to regulatory capital multiple of less than 85% of the Superintendent’s maximum permitted assets to capital multiple. The Superintendent permits us to maintain an assets to capital multiple of up to 20 times. We target to be prudently below CDIC’s more conservative threshold of 17 times and at December 31, 2003, our multiple was 14.7 times.

# Management's Discussion and Analysis (continued)

We have formal capital management policies, which have been approved by our Board of Directors and HSBC Holdings and which have been reviewed by the applicable regulatory authorities in Canada. Our capital management policies lay out a strict regime of capital monitoring, targets, limits and maintenance actions. Our Finance and Treasury Departments manage compliance with our policies daily, with weekly monitoring by our Asset and Liability Committee ("ALCO"). ALCO is chaired by our Chief Financial Officer and includes the Chief Executive Officer, Chief Operating Officer and certain of our senior executives, including those responsible for credit, risk management, marketing and sales, and treasury.

We employ well-developed personal and commercial relationship management performance measurement tools to ensure that our shareholder capital is efficiently deployed in our major business segments. These tools measure the value added by each customer relationship against the capital required to support the risk-taking facilities granted. Capital necessary to support customers is determined according to the various requirements of the Superintendent. We monitor and adopt a variety of capital management techniques in order to manage the maximization of shareholder value against the fundamental need to be prudently capitalized.

## Regulatory capital ratios

The components of our regulatory capital and the regulatory capital ratios are as follows:

| | 2003 | 2002 |
|---|---|---|
| **Tier 1 capital** | | |
| Common shares | **$ 950** | $ 950 |
| Contributed surplus | **169** | 165 |
| Retained earnings | **575** | 433 |
| Non-cumulative preferred shares | **125** | 125 |
| Non-controlling interests in trust and subsidiary(1) | **230** | 230 |
| Goodwill | **(15)** | (15) |
| Total Tier 1 capital | **2,034** | 1,888 |
| **Tier 2 capital** | | |
| Subordinated debentures (net of regulatory amortization) | **457** | 492 |
| General allowance for credit losses | **211** | 198 |
| Total Tier 2 capital | **668** | 690 |
| **Total Tier 1 and Tier 2 capital** | **2,702** | 2,578 |
| Securitization-related deductions | **(18)** | (6) |
| **Total capital available for regulatory purposes** | **$ 2,684** | $ 2,572 |
| **Total risk-weighted assets** | **$ 24,163** | $ 22,659 |
| **Regulatory capital ratios** | | |
| Tier 1 capital | **8.4%** | 8.4% |
| Total capital | **11.1%** | 11.4% |
| **Assets to capital multiple** | **14.7x** | 14.4x |

(1) *Includes $200 million of innovative Tier 1 HSBC Canada Asset Trust Securities (HSBC HaTS™)*

## Risk-weighted assets

Risk-weighted assets requiring capital support arise primarily from the provision of credit and other risk facilities to our customers. We determine risk-weighted assets by applying the specific weighting factors provided by the Superintendent's capital adequacy guidelines. Our risk-weighted assets are as follows:

| | 2003 | 2002 |
|---|---|---|
| **On-balance sheet assets** | | |
| Cash resources | $ 705 | $ 699 |
| Securities | 240 | 348 |
| Mortgage loans | 4,893 | 4,446 |
| Other loans | 12,680 | 12,797 |
| Acceptances | 3,247 | 2,374 |
| Other assets | 582 | 529 |
| **Total on-balance sheet assets** | 22,347 | 21,193 |
| **Off-balance sheet instruments** | | |
| Guarantees and letters of credit | 1,236 | 1,031 |
| Other | 403 | 292 |
| **Subtotal** | 1,639 | 1,323 |
| Derivatives (at risk weighted equivalents) | 177 | 143 |
| **Total off-balance sheet instruments** | 1,816 | 1,466 |
| **Total risk-weighted assets** | $ 24,163 | $ 22,659 |

## Regulatory capital generation

We generated regulatory capital through the following sources:

| | 2003 | 2002 |
|---|---|---|
| **Internally generated capital** | | |
| Net income | $ 300 | $ 260 |
| Dividends | (158) | (208) |
| General allowance for credit losses | 13 | 12 |
| Other | (8) | (4) |
| | 147 | 60 |
| **External financing** | | |
| Issue of common equity | – | 15 |
| Subordinated debentures (net of regulatory amortization) | (35) | 86 |
| **Total increase in regulatory capital** | $ 112 | $ 161 |

In 2003, our operations generated more capital than was required by the business and dividends of $150 million were paid on common shares. During 2003, the amount of our Tier 2 capital decreased by $24 million due to the impact of the weaker US dollar on our US$85 million Tier 2 capital subordinated debenture.

In addition to internally generated capital, from time to time we have issued subordinated debenture capital through private placements as well as issuing preferred shares and capital trust securities through a public markets issue. We have also issued common shares and subordinated debentures to the HSBC Group.

It is expected that during 2004 we will be able to generate sufficient capital to support our business and capital requirements.

# Management's Discussion and Analysis (continued)

## Risk Management

All of our business activities require the management of particular risks or combinations of risks. Risk management is the identification, analysis, evaluation and management of the factors which could adversely affect our resources, operations and financial results. The risk factors most likely to affect us are market, structural, liquidity, fiduciary, operational and credit risks. We believe our exposure to these risk factors is managed conservatively. We have established formal risk management policies which identify and analyze these risk elements and, where required, we set appropriate risk limits. We continually monitor these risks and limits by means of internal control measures, which we consider are up to date and reliable.

We review and modify our risk management policies and systems regularly to reflect any operational changes either internally or in the markets in which we operate. Our Board of Directors approve our risk management policies and overall risk management limits are set, taking into account HSBC Holdings' overall risk limits.

ALCO is responsible for measuring, monitoring and controlling market, structural and liquidity risks, while our Audit and Credit Committees are responsible for credit risk management.

Our Risk Management Committee is responsible for managing all other significant risks to which we are exposed. The Risk Management Committee:

- Identifies and measures risks we are exposed to and considers whether those risks are significant;
- Develops and recommends for approval, appropriate risk management policies and procedures regarding those activities and units which incur significant risk, including extraordinary event planning;
- Provides direction regarding our overall risk philosophy and appetite including consideration and acceptability of new or unusual risk;
- Monitors our adherence to risk management policies and procedures; and
- Reports any policy or major practice change, unusual situations, significant exceptions, new strategy or products to our Executive Committee, Audit Committee and Board for review, ratification or approval.

### Market risk

Market risk is the risk to our financial condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices on a portfolio of trading assets. Market risk arises on financial instruments included in our trading book. Trading book assets are valued at market prices and as prices rise and fall, depending on market factors and conditions, our earnings will be directly impacted.

We make markets in interest rate, exchange rate and equity derivative instruments, as well as in debt, equity and other securities. Trading risks arise either from customer-related business or principal investing activities, where we trade investments for our own account.

Market risk is managed through risk limits set out by ALCO and approved by our Board of Directors. We set risk limits for each of our trading operations dependent upon the size, financial and capital resources of the counterparty, market liquidity of the instruments traded, business plan, experience and track record of management and dealers, internal audit ratings, support function resources and computer systems. Risk limits are reviewed and set by ALCO on an annual basis at a minimum.

We conduct reviews using a combination of risk measurement techniques, including present value of a basis point ("PVBP"), value at risk ("VaR"), foreign exchange exposure limits, maximum loss limits, options premium paid limits and product and issuance limits. PVBP is a sensitivity measure which calculates the impact on the present value of a transaction (or a portfolio of transactions) of a one basis point movement in rates. VaR is a statistical technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence.

## Structural Risk

Structural risk consists of interest rate risk and foreign exchange risk as it relates to assets and liabilities included in the banking book, including those in our consolidated balance sheet and any off-balance sheet items used as hedges. We value instruments included in the banking book at cost plus accrued interest (the accrual basis) and changes in rates and prices will not directly impact earnings. However, to the extent that assets and liabilities are not directly matched either by interest or exchange rates, any changes in the mix of assets or liabilities will affect earnings.

### Interest rate risk

Interest rate risk arises primarily out of differences in the term to maturity or repricing of our assets and liabilities both on and off balance sheet. These interest rate risk exposures, or "gaps", are monitored by ALCO on a weekly basis against prescribed limits. The gap position measures assets and liabilities based on contractual repricing data as well as incorporating assumptions on customer behaviour on products with a degree of optionality as to prepayment, redemption or repricing (such as redeemable deposit products and mortgages with prepayment options). These assumptions, which are based on historical behavioural patterns, are periodically reviewed by ALCO.

We believe in a conservative approach in setting limits on these mismatched positions. Limits are established based on the impact on net interest income of an immediate and parallel upward shift in the relevant yield curves of 1%. We also have established limits on these mismatched positions in terms of Dollars at Risk, VaR and PVBP.

We use a variety of cash and derivative instruments (principally interest rate swaps) to manage our interest rate risk. We use derivatives to modify the interest rate characteristics of related balance sheet instruments and to hedge anticipated exposures when market conditions of price and liquidity are considered beneficial.

Interest rate risk also arises in the fixed income trading activities. We have established limits in terms of VaR, PVBP, maximum loss limits, product and issuance limits, and premium paid limits for option contracts.

In managing interest rate risk, the Bank relies primarily upon its contractual interest rate sensitivity position adjusted for certain assumptions regarding customer behavioral preferences, which are based upon historical trends. Adjustments made include assumptions relating to early repayment of consumer loans and residential mortgages and customer preferences for demand, notice and redeemable deposits. Based upon these adjustments, it is estimated that an immediate and sustained parallel increase in interest rates of 1% across all currencies and maturities would increase net interest income by $33 million (2002 - decrease of $4 million) over the next twelve months assuming no additional hedging is undertaken.

### Foreign exchange risk

We are exposed to foreign exchange risk on our foreign currency denominated asset and liability positions. We buy and sell currencies in the spot, forward, futures and options markets, on behalf of our customers and for our own account, to manage our own currency exposures arising from assets and liabilities denominated in currencies other than the Canadian dollar. Limits have been established as to the magnitude of the exposure on a currency-by-currency basis as well as maximum loss limits on any position held.

## Liquidity risk

Liquidity risk is the risk that we will be unable to fund our obligations as they come due because of our inability to liquidate assets or obtain adequate funding (funding liquidity risk), or cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (market liquidity risk).

We manage the liquidity structure of our assets, liabilities and commitments so cash flows are appropriately balanced and all funding obligations are met when due. We also ensure compliance with Canadian regulatory requirements. Our Treasury department manages liquidity on a day-to-day basis.

As part of management of both our liquidity and interest rate risks, we have an overall flexible funding strategy to cover both short and long term liquidity needs as well as a contingency plan to cover unexpected or unusual situations which could lead to market disruptions.

## Management's Discussion and Analysis (continued)

Customer deposits form a significant portion of our overall funding. Considerable importance is placed on the growth of our core deposit base which provides a diversified and stable pool of funds. We access capital markets for the purposes of providing additional wholesale funding, maintaining a presence in the marketplace and aligning asset and liability maturities. As part of our wholesale funding arrangements, we have a number of programs for fundraising activities, including arranging facilities with major Canadian institutional lenders and borrowers, so that undue reliance is not placed on any one source of funding. Sources of funding also include asset securitizations.

We have established limits for balance sheet ratios and minimum periods of forecast positive cumulative cash flow as well as contingencies to meet cash flow needs. As part of this contingency, we can access the considerable resources of the HSBC Group and currently have a US$300 million standby borrowing facility from our US affiliate, although no amounts have been drawn from this facility since its inception in 1997.

ALCO oversees compliance with liquidity requirements on a weekly basis by monitoring:

- projected cash flows and the levels of related liquid assets,
- specified balance sheet liquidity ratios against prescribed limits,
- depositor concentration in terms of overall funding mix and to avoid undue reliance on large individual and non-core depositors; and
- liquidity contingency plans.

As part of our normal business operations we have a number of contractual obligations for payment of liabilities. Amounts included in unsecured long-term funding in the table below are customers' term deposits with an original term to maturity more than one year based on contractual repayment dates. We manage our funding requirements based on historical customer behavioural patterns, and we may not actually be required to repay these obligations on the due date. Also included are obligations related to commitments not recorded in the balance sheet, such as those relating to operating leases. A summary of our future contractual obligations at December 31, 2003 is as follows:

| | *Payments due by period* | | | | |
|---|---|---|---|---|---|
| | *Less than 1 year* | *1 to 3 years* | *4 to 5 years* | *After 5 years* | *Total* |
| Subordinated debentures | $ – | $ 60 | $ – | $ 444 | $ 504 |
| Operating leases | 34 | 55 | 35 | 46 | 170 |
| Committed purchase obligations | 3 | – | – | – | 3 |
| Unsecured long term funding | 544 | 1,809 | 624 | – | 2,977 |
| Total contractual obligations | $ 581 | $ 1,924 | $ 659 | $ 490 | $ 3,654 |

Not included in the table are any commitments relating to customers utilizing undrawn portions of their loan facilities. Total undrawn facilities at December 31, 2003 were $15,538 million for facilities expiring before December 31, 2004 and $3,055 million for facilities expiring after that date.

We expect to be able to meet all of our funding and other commitments in the normal course of our operations.

### Fiduciary risk

Fiduciary risk is the risk we will provide improper sales or investment advice to clients or manage clients' assets incorrectly or inappropriately. Fiduciary risk differs from the risks we face as intermediaries, as it arises from our dealing with or advising on the assets owned by our customers. Fiduciary risk requires us to conduct activities in a manner consistent with our customers' stated objectives and to place the interests of the customer ahead of our own interests.

Fiduciary risk is controlled and managed by ensuring our clients establish appropriate investment goals and mandates through the appropriate "know your client" actions and ensuring our staff follow correct procedures when exposed to fiduciary issues. This control structure is complemented by independent and periodic reviews by our Internal Audit and Compliance functions.

## Operational risk

Operational risk is the risk of loss to us resulting from inadequate or failed internal processes and systems, human error or from external events. This type of risk includes fraud, unauthorized activities, errors, and settlement risk arising from the large number of daily banking transactions occurring in the normal course of business. Also, there are a wide variety of business and event risks such as legal, taxation, regulatory, human resources and reputation inherent in all business activities.

We have policies for managing operational risk and aim to minimize loss through a framework requiring all units to identify, assess, monitor and control operational risk. This identification and self-assessment process is subject to a review by our Risk Management Committee, and approval by our Board of Directors.

We manage operational risk through disciplined application and evaluation of internal controls, appropriate segregation of duties, independent authorization of transactions, and regular, systematic reconciliation and monitoring of transactions. This control structure is complemented by independent and periodic reviews by our Internal Audit department.

In addition to an enterprise-wide risk management process, we have established business continuity and event management practices so we can continue to service our customers' needs in the event of major business disruption such as the blackout experienced in the summer of 2003. Transfer of our data processing centre and back-up facility to HSBC Group's state of the art, Global Data Center located in New York state, USA has considerably enhanced our operational and disaster recovery capabilities.

## Credit risk

Credit risk arises when we place reliance on our borrowers and other counterparties to honour their contractual obligations to us arising out of credit granting, credit substitutes (such as letters of credit and guarantees) and contingent risk relating to derivative contracts such as forward foreign exchange contracts and interest rate swaps. Concentration of credit risk may arise when the ability of a number of borrowers or other counterparties to meet their contractual obligations are similarly affected by external factors. Examples of concentration risk would include geographic, industry or environmental factors. Therefore, diversification of credit risk is a key concept by which we are guided.

Credit risk is managed in accordance with our credit policy, established after consultation with HSBC Group, that has been approved by our Board of Directors. Risk limits and credit authorities are delegated to senior credit management staff, who in turn delegate appropriate limits to line management depending upon circumstances. Credit exposures in excess of certain levels may require the concurrence of HSBC Group, to ensure they remain within their global risk limits.

Our Board of Directors and Audit Committee meet quarterly to review portfolio credit quality, geographic, product and industry distributions, large customer concentrations and adequacy of loan provisions. Policies relating to large customer concentration and industry, product and geographic distribution are approved by our Board in line with HSBC Group policy. All new major authorized facilities, derivative exposures and special credit problem facilities are also reviewed quarterly by the Audit Committee of our Board. The appetite for credit risk is expressed through Commercial and Personal Lending Guidelines that conform with HSBC Group guidelines and are approved quarterly by the Audit Committee of the Board and disseminated throughout the Bank.

We have a disciplined approach to managing credit risk through ongoing monitoring of all credit exposures at branches, with weaker quality credits being reviewed at more frequent intervals. Problem and impaired loans are identified at an early stage and are actively managed by a separate dedicated Special Credit management unit. Our Credit Department reviews and adjudicates credit risk outside of branch manager's delegated lending limits and they review branch credit decisions to ensure these decisions reflect our portfolio management objectives. Our Credit Department may approve credits not meeting our lending guidelines on an exception basis with appropriate risk mitigation and reward considerations.

Exposure to banks and financial institutions involves consultation with a dedicated unit within the HSBC Group that controls and manages these exposures on a global basis. Similarly cross-border risk is also controlled globally by this unit through the imposition of country limits. A review of all credit matters undertaken by our branch and head office credit managers is completed regularly by our internal auditors to ensure all our policies, guidelines, practices, conditions and terms are followed.

## Management's Discussion and Analysis (continued)

Segmentation of credit risk is ensured through a formal and strictly managed risk grading system that is assigned to all borrowing clients and monitored closely to ensure changes in credit risk are mapped to the appropriate credit grade. This grading system is in transition to a more granular model to comply with the requirements of the new Basel II Capital Accord. We use credit scoring and related bureau-based management techniques, along with judgement to manage risk associated with our personal clients.

Other initiatives are also being developed along with the HSBC Group in preparation for the Basel II accord. We are implementing a number of changes in respect of our commercial and personal credit infrastructure and systems to improve risk assessment and to enhance efficiency, productivity and customer service. In our branch network in 2003, we enhanced our Credit Approval and Relationship Management system ("CARM"), which is linked with Moody's Risk Advisor, a risk assessment tool. In 2004, we expect to introduce a number of additional HSBC Group software and infrastructure solutions for automated personal credit scoring and relationship management tools. This will further provide faster credit decisions for customers, while enhancing our risk management process.

We manage real estate lending within well-defined parameters with an emphasis on relationship and project sponsorship for all new transactions. Where we are dependent upon third parties for establishing asset values, consistent and transparent valuations are ensured through maintaining a list of approved professionals that meet our standards.

We believe we have a strong control environment to ensure credit risks are appropriately managed through our conservative lending practices, accurate recording, and strict approval and monitoring processes. Historically, our average percentage credit loss experience has been amongst the lowest of our peer group of major Canadian chartered banks.

### Loan portfolio

In assessing our loan portfolio, we include all of our credit exposures, including customers' liabilities under acceptances, guarantees and letters of credit. The following is an analysis of the constituents of our portfolio:

**Analysis of Loans**

| | **2003** | 2002 |
|---|---|---|
| Loans included in financial statements, net of allowances | **$ 24,933** | $ 23,869 |
| Allowance for credit losses | **313** | 311 |
| Customers' liabilities under acceptances | **3,247** | 2,374 |
| Letters of credit | **421** | 434 |
| Guarantees | **1,421** | 1,244 |
| Total loans | **30,335** | 28,232 |
| Non-performing loans | **(203)** | (225) |
| **Total performing loans** | **$ 30,132** | $ 28,007 |

The following tables, in which business and government loans includes customers' liabilities under acceptances, letters of credit and guarantees, provide details of our overall performing loan portfolio including geographic and industry distribution:

**Performing loan portfolio**

| | 2003 | | 2002 | |
|---|---|---|---|---|
| Consumer loans | **$ 2,688** | **8.9%** | $ 2,405 | 8.6% |
| Residential mortgages | **10,857** | **36.1%** | 9,785 | 34.9% |
| Total consumer | **13,545** | **45.0%** | 12,190 | 43.5% |
| Business and government loans | **16,587** | **55.0%** | 15,817 | 56.5% |
| **Total performing loans** | **$ 30,132** | **100.0%** | $ 28,007 | 100.0% |

**Geographic distribution**

| | 2003 | | 2002 | |
|---|---|---|---|---|
| British Columbia | **$ 14,689** | **48.7%** | $ 13,552 | 48.4% |
| Western Canada | **4,196** | **14.0%** | 3,839 | 13.7% |
| Ontario | **7,931** | **26.3%** | 7,701 | 27.5% |
| Quebec and Atlantic | **3,316** | **11.0%** | 2,915 | 10.4% |
| **Total performing loans** | **$ 30,132** | **100.0%** | $ 28,007 | 100.0% |

**Business and government loan portfolio by industry**

| | 2003 | | 2002 | |
|---|---|---|---|---|
| Real estate | **$ 4,818** | **29.0%** | $ 4,489 | 28.4% |
| Hotels and hospitality | **916** | **5.5%** | 920 | 5.8% |
| Trade | **2,791** | **16.8%** | 2,699 | 17.1% |
| Services | **2,896** | **17.5%** | 2,785 | 17.6% |
| Manufacturing | **2,415** | **14.6%** | 2,195 | 13.9% |
| Other | **2,751** | **16.6%** | 2,729 | 17.2% |
| **Total business and government loans** | **$ 16,587** | **100.0%** | $ 15,817 | 100.0% |

Large customer concentrations are borrowing groups where approved facilities exceed 10% of our regulatory capital base. At December 31, 2003, 10% of this amounted to approximately $268 million. The following table provides details of our large customer concentrations:

**Large customer concentration**

| | 2003 | 2002 |
|---|---|---|
| Large customer concentration | **$ 2,325** | $ 2,206 |
| As a percentage of business and government loans | **14.0%** | 14.0% |
| As a percentage of total performing loans | **7.7%** | 7.9% |

# Management's Discussion and Analysis (continued)

## Credit quality

We categorize the credit quality of our loan portfolio as follows:

- *Satisfactory* – Borrower's financial condition and future capacity to repay is considered satisfactory.
- *Watch* – Borrower's financial condition has shown sustained or continued deterioration and requires frequent monitoring. The capacity to repay remains satisfactory.
- *Sub-standard* – Borrower's financial condition is weak. However, we still expect that full repayment will be received.
- *Impaired* – We consider loans impaired if an amount is contractually 90 days in arrears or our management is of the opinion there is no longer reasonable assurance as to the ultimate collectibility of all or some portion of principal or interest. Impaired loans are classified as non-performing. Specific provision is made for any anticipated loss.

The following table sets forth an analysis of our total loan portfolio on the basis of the above credit quality categories:

**Performing and non-performing loan portfolio**
**Credit quality**

| | 2003 | | 2002 | |
|---|---|---|---|---|
| Satisfactory | **$ 28,998** | **95.6%** | $ 26,774 | 94.9% |
| Watch | **821** | **2.7%** | 861 | 3.0% |
| Sub-standard | **313** | **1.0%** | 372 | 1.3% |
| Impaired | **203** | **0.7%** | 225 | 0.8% |
| **Total loans** | **$ 30,335** | **100.0%** | $ 28,232 | 100.0% |

More than 95% of our total loan portfolio is categorized as satisfactory. Credit quality of the portfolio has remained stable over the past five years. At December 31, 2003, $203 million (0.7%) of the loan portfolio was impaired, with specific and general allowances providing 154% (December 31, 2002 - 138%) coverage of these loans.

## Impaired loans and allowances for credit losses

We maintain allowances for credit losses at a level to absorb all estimated credit-related losses in the portfolio, which may arise from both on and off balance sheet credit exposures. These exposures include deposits with other regulated financial institutions, loan substitute securities, loans, acceptances, derivative instruments and other credit-related contingent liabilities, such as letters of credit and guarantees.

Assessing the adequacy of the allowance for credit losses is inherently subjective as we make estimates, including the amount and timing of expected future cash flows, that may be susceptible to significant change. Specific allowances are recorded on a loan-by-loan basis for those loans where we believe the ultimate collectibility of all or some portion of principal or interest is in doubt, to reduce the book value to expected recovery level. We determine the level of specific allowances on an individual asset basis for all commercial loans and some consumer loans, while a formula approach is utilized for consumer loans with similar characteristics. We use a number of methods to determine specific allowances, including discounted value of future cash flows, observable market values or the fair values of the underlying security. We review impaired loans at least quarterly and record specific provisions based on estimated net realizable amounts.

The general allowance represents our best estimate of probable losses within the portion of our portfolio that we have not yet specifically identified as impaired. We have established a methodology for use in establishing general allowances. This methodology involves the application of expected loss factors to outstanding and undrawn facilities. The general allowance for large business and government loans and acceptances in the model is based on the application of expected default and loss factors. For more homogeneous portfolios, such as our residential mortgages, small and mid market business loans and personal loans, we have determined the general allowance on a product portfolio basis. We determine the losses by the application of loss ratios through analysis of write-off trends over an economic cycle, adjusted to reflect

changes in our product offerings and credit quality of the pool. We have also made portfolio adjustments that include consideration of general economic, geographic and business conditions, recent loan loss experience and trends in credit quality and concentrations, particularly where our loss experience is considered low in relation to the industry as a whole. This allowance also reflects model and estimation risk, but does not represent future losses.

The following table provides details of the impaired loan portfolio:

| **Impaired loan portfolio** | **2003** | 2002 |
|---|---|---|
| Business and government | | |
| Real estate | **$ 55** | $ 53 |
| Manufacturing | **36** | 38 |
| Trade | **20** | 26 |
| Services | **8** | 8 |
| Other | **47** | 59 |
| Total business and government loans | **166** | 184 |
| Personal | | |
| Consumer loans | **14** | 16 |
| Residential mortgages | **23** | 25 |
| Total personal loans | **37** | 41 |
| Total impaired loans | **$ 203** | $ 225 |
| Specific allowances | **$ 55** | $ 80 |
| General allowances | **258** | 231 |
| Total allowance for credit losses | **$ 313** | $ 311 |
| **Net impaired loans** | **$ (110)** | $ (86) |

The following table shows the coverage of specific allowances as a percentage of our related impaired loans:

| **Coverage of business and government loans by specific allowance** | **2003** | 2002 |
|---|---|---|
| Real estate | **11%** | 21% |
| Manufacturing | **28%** | 45% |
| Other | **40%** | 46% |
| Total | **28%** | 39% |

The following table sets out the coverage of general provisions as a percentage of total performing loans and risk-weighted assets. We consider this level of general allowances to be adequate in relation to its methodology, the Superintendent's benchmark formula and our major domestic bank peers.

| **Coverage by general allowance** | **2003** | 2002 |
|---|---|---|
| As a percentage of total performing loans | **0.86%** | 0.82% |
| As a percentage of risk-weighted assets | **1.07%** | 1.02% |

# Management's Discussion and Analysis (continued)

### Provisions for credit losses

The following table sets out the provisions for credit losses charged to income. Specific provisions have decreased in 2003 compared to 2002 when we were exposed to a small number of commercial credit facilities, concentrated in the Canadian telecommunications sector.

| | 2003 | 2002 |
|---|---|---|
| Specific provisions | $ 37 | $ 135 |
| General provisions | 24 | (8) |
| **Total provision for credit losses** | **$ 61** | $ 127 |
| **Specific provisions as a percentage of total loan portfolio** | **0.12%** | 0.48% |

### Derivative portfolio

The credit equivalent amount of derivative exposure comprises the current replacement cost of positions plus an allowance for potential future fluctuation of interest rate or foreign exchange rate derivative contracts. We enter into derivatives primarily to support our customers' requirements and to assist us in the management of assets and liabilities particularly relating to interest and foreign exchange rate risks as noted above. The credit equivalent amount of our derivative portfolio by product type is as follows:

| **Products** | 2003 | 2002 |
|---|---|---|
| Interest rate contracts | $ 150 | $ 188 |
| Foreign exchange contracts | 521 | 406 |
| Equity contracts | 3 | 12 |
| Total | 674 | 606 |
| Impact of master netting agreements | (39) | (106) |
| **Net credit equivalent amount** | **$ 635** | $ 500 |

## Related Party Transactions

As a member of one of the world's largest financial services organizations, we benefit from the expertise provided by a number of other members of the HSBC Group as well as economies of scale. In our case, we outsource a number of functions to other Group companies, share costs of development for computer systems used around the world and benefit from international contracts for advertising and marketing research, training and other areas. In addition, HSBC Holdings guarantees all of our customers' deposits.

All such transactions are related party transactions and are subject to formal procedures we have adopted to comply with the Bank Act. All transactions must be pre-approved either by our legal department or, if above certain thresholds, by our Executive Committee. This additional scrutiny ensures that we meet our obligation to ensure transactions are priced and accounted for as if they were provided in an open market on an arms-length basis or, where no market exists, ensure we receive fair value. In addition, taxation and revenue authorities in Canada and other countries may disallow transactions which are not priced on an arms-length fair value basis.

For 2003, the total amount we paid to other HSBC Group companies in respect of these transactions was $84 million. There are also a number of routine transactions occurring during the course of the year, none of which are individually material to our results.

## Analysis of Financial Results and Operations by Customer Group

We report and manage our operations according to customer group definitions used by the HSBC Group. For 2003, we have combined *Wholesale Banking* and *Treasury and Markets* into one customer group *Corporate, Investment Banking and Markets.* We have reclassified the comparative information to reflect this new structure. Also consistent with HSBC Group's customer groupings, *Commercial Financial Services* has been renamed *Commercial Banking.*

Effective January 1, 2003, we implemented a funds transfer pricing system which shifts structural interest rate risk from business units to our Treasury department, which is part of CIBM. Refinements to funding and cost allocations have also been implemented. All of these enhancements have been applied to the comparative results of the customer groups.

The following is a summary of selected consolidated financial information and other data for each of our major customer groups:

| | 2003 | | | | |
|---|---|---|---|---|---|
| | *Personal Financial Services* | *Commercial Banking* | *Corporate, Investment Banking & Markets* | *Other*[1] | *Total* |
| Net interest income | **$ 317** | **$ 408** | **$ 142** | **$ –** | **$ 867** |
| Other income | **242** | **127** | **94** | **–** | **463** |
| Total revenues | **559** | **535** | **236** | **–** | **1,330** |
| Provision for credit losses | **(10)** | **(47)** | **(4)** | **–** | **(61)** |
| Non-interest expenses | **(412)** | **(248)** | **(49)** | **(55)** | **(764)** |
| Net income before the under noted | **137** | **240** | **183** | **(55)** | **505** |
| Provision for income taxes | **(51)** | **(90)** | **(69)** | **21** | **(189)** |
| Non-controlling interest in income of trust | **(5)** | **(8)** | **(3)** | **–** | **(16)** |
| Net income | **$ 81** | **$ 142** | **$ 111** | **$ (34)** | **$ 300** |
| Percentage of total net income | **27.0%** | **47.3%** | **37.0%** | **(11.3%)** | **100.0%** |
| Average assets | **$ 13,600** | **$ 12,678** | **$ 10,357** | **–** | **$ 36,635** |
| Percentage of total average assets | **37.1%** | **34.6%** | **28.3%** | **–** | **100.0%** |

| | 2002 (restated) | | | | |
|---|---|---|---|---|---|
| | *Personal Financial Services* | *Commercial Banking* | *Corporate, Investment Banking & Markets* | *Other*[1] | *Total* |
| Net interest income | $ 323 | $ 399 | $ 134 | $ – | $ 856 |
| Other income | 204 | 134 | 103 | – | 441 |
| Total revenues | 527 | 533 | 237 | – | 1,297 |
| Provision for credit losses | (9) | (48) | (70) | – | (127) |
| Non-interest expenses | (365) | (219) | (94) | (52) | (730) |
| Net income before the under noted | 153 | 266 | 73 | (52) | 440 |
| Provision for income taxes | (57) | (100) | (28) | 21 | (164) |
| Non-controlling interest in income of trust | (5) | (8) | (3) | – | (16) |
| Net income | $ 91 | $ 158 | $ 42 | $ (31) | $ 260 |
| Percentage of total net income | 35.0% | 60.8% | 16.2% | (11.9%) | 100.0% |
| Average assets | $ 11,757 | $ 13,036 | $ 10,034 | – | $ 34,827 |
| Percentage of total average assets | 33.8% | 37.4% | 28.8% | – | 100.0% |

(1) *Other includes the effect of consolidation adjustments and unallocated revenues and expenses.*

# Management's Discussion and Analysis (continued)

## Personal Financial Services

*Client Base.* PFS provides services to individuals through a segmented approach to understanding and meeting customer needs. Similarly, sales management maintains a balanced approach, focused on meeting clients' needs. To build on our high level of customer satisfaction, emphasis has and will continue to be placed on developing people and systems infrastructure to improve relationship management and effectiveness of cross-selling. PFS staff in branches are the main focus of our strategy. We train most of our staff to have a broad knowledge allowing them to deliver and sell a wide range of services and products to meet the needs of our clients. However, our staff are also able to quickly recognize cross-selling opportunities which require additional delivery or service requirements, making recommendations to customers to consult specialists for assistance.

*Products and Services.* PFS offers a comprehensive range of financial products and services, including the following:

| *Personal Banking* | *Asset Management* | *Brokerage* | *Personal Trust Services* |
|---|---|---|---|
| Deposits and personal chequing accounts | Mutual funds | Full service | Estate planning |
| Residential mortgages | Segregated funds | Discount | Wills |
| Lines of credit | Personal portfolio management | | Investment administration |
| Personal loans | | | Executor and trustee services |
| Investments | | | |
| Debit and credit cards | | | |
| Telephone banking | | | |
| Internet banking | | | |
| HSBC *Premier* | | | |
| HSBC *Premier* International Services | | | |
| Private client services | | | |
| Retirement products | | | |
| Creditor and Travel Insurance | | | |

*Delivery Channels.* We provide personal financial products and services through over 160 offices, including over 120 branches as well as subsidiary offices including HSBC Asset Management and HSBC Securities, as well as ABMs, direct debit, Internet and telephone call centres.

*Selected Financial Information and Analysis.* The following sets out consolidated financial information and other data for PFS:

| | **2003** | 2002 |
|---|---|---|
| Net interest income | **$ 317** | $ 323 |
| Other income | **242** | 204 |
| Total revenues | **559** | 527 |
| Provision for credit losses | **(10)** | (9) |
| Non-interest expenses | **(412)** | (365) |
| Net income before the under noted | **137** | 153 |
| Provision for income taxes | **(51)** | (57) |
| Non-controlling interest in income of trust | **(5)** | (5) |
| Net income | **$ 81** | $ 91 |
| Average assets | **$ 13,600** | $ 11,757 |

Lower interest rates and an active housing market fuelled growth in residential mortgages and average interest earning assets increased considerably during 2003. However, this was more than offset by a contraction in spreads resulting in a decline in net interest income. The competitive market also reduced the spread contribution from customers' fixed deposits.

We recorded an increase in other income arising from higher net fees and commissions from our full service retail and discount brokerage activities. This resulted from a full year's contribution from HIDC as well as increased transaction volumes arising from the strengthening of equity markets in 2003. Securitization income also increased due to higher volumes of loans sold in 2003. This was partially offset by a decline in mutual fund fees. We earned higher net underwriting income from our insurance activities due to increased business and higher retention rates.

We recorded increased staff costs resulting from higher variable compensation expenses related to increased business volumes from retail brokerage and higher overall net income. Also contributing to higher staff expenses was a full year's salary expense from HIDC, a charge for headcount reduction and expensing of stock option benefits in 2003. Expenses also increased due to higher operating costs associated with increased business volumes particularly related to retail equity trading. We absorbed a full year's operating costs from HIDC. These were partially offset by lower operating losses in 2003 compared with 2002.

In 2004, we signed a letter of intent to sell HSBC Canadian Direct Insurance Inc., subject to definitive documentation and regulatory approval. This is consistent with our decision to focus resources on expanding our core business operations which are integrated and national in nature.

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## Commercial Banking

*Client Base.* CMB, which includes our small and medium sized enterprise business, is one of the HSBC Group's traditional strengths, both in Canada and worldwide. We serve a wide range of customers, from sole proprietors to publicly listed companies. HSBC is a popular choice for commercial customers looking for a comprehensive range of financial services and excellent customer service.

*Products and Services.* CMB provides credit, cash management, treasury, trade finance, investment banking and other financial services and products to businesses in Canada, including the following:

| *Commercial and Corporate Banking* | *Asset Management* | *Investment Banking* | *Merchant Banking* | *Treasury* | *Trade Finance* |
|---|---|---|---|---|---|
| Lines of credit<br>Term financing<br>Deposits<br>Cash management<br>Leasing<br>Merchant credit card services and point of sale terminals<br>Business Internet banking<br>Hexagon<br>Creditor life insurance | Portfolio and fund management<br>Group RRSP<br>Mutual funds | Corporate finance<br>Mergers and acquisitions<br>Advisory | Mezzanine finance<br>Subordinated debt<br>Working capital<br>Private equity | Foreign exchange<br>Deposits<br>Fixed income<br>Derivatives | Import and export finance |

*Delivery Channels.* We provide CMB through commercial branches and subsidiary offices, including those of HSBC Securities, HSBC Asset Management and HSBC Capital Canada as well as through HSBC Group offices in 79 countries and territories. Direct delivery channels include the Internet and Telephone Banking.

## Management's Discussion and Analysis (continued)

*Selected Financial Information and Analysis.* The following sets out consolidated financial information and other data for CMB:

| | **2003** | 2002 |
|---|---|---|
| Net interest income | **$ 408** | $ 399 |
| Other income | **127** | 134 |
| Total revenues | **535** | 533 |
| Provision for credit losses | **(47)** | (48) |
| Non-interest expenses | **(248)** | (219) |
| Net income before the under noted | **240** | 266 |
| Provision for income taxes | **(90)** | (100) |
| Non-controlling interest in income of trust | **(8)** | (8) |
| Net income | **$ 142** | $ 158 |
| Average assets | **$ 12,678** | $ 13,036 |

Although loans decreased resulting from the sale of our Seattle and Portland branches, we increased net interest income arising from higher loan fees included as interest and from higher commercial deposits.

In 2003, we increased revenues from bankers' acceptances, as the interest rate environment favoured short-term borrowing. However, other income was lower in 2003 mainly due to lower revenue from service charges, lower trade finance fees and lower income from our merchant banking investments.

Salaries and benefits were higher in 2003 due to increased complement, a charge for headcount reduction and expensing of stock option benefits in 2003. Other expenses also increased largely due to higher operating losses.

### Corporate, Investment Banking and Markets

*Client Base.* CIBM provides a comprehensive range of corporate financial services to an international group of our large multinational clients as well as managing our Treasury Department. Our focus is on entities that have a need for international value added products through investment banking, structured lending and trade services by offering the following: corporate banking, asset management, investment banking, merger and acquisition advisory, treasury and trade finance.

*Products and Services.* CIBM provides the following products and services:

| *Corporate Banking* | *Asset Management* | *Investment Banking* | *Treasury* | *Balance Sheet Management and Proprietary Trading* |
|---|---|---|---|---|
| Lines of credit | Portfolio and fund management | Corporate finance | Foreign exchange | Foreign exchange trading and hedging |
| Term financing | Group RRSP | Mergers and acquisitions | Derivatives | Interest rate hedging |
| Deposits | | Advisory | Bankers' acceptances | Funding |
| Payments and cash management | | | Treasury bills | Investment/ money market |
| Leasing | | | Commercial paper | Liquidity management |
| Import and export trade finance | | | Medium term notes | Fixed income sales and trading |
| | | | Fixed income sales and trading | Derivatives |
| | | | | Client facilitation |

*Delivery Channels*. We provide CIBM services through our principal branches and subsidiary offices, coordinated with HSBC Group worldwide operations. Our customers in this group deal with the HSBC Group worldwide through a relationship manager. We provide relationship management coverage to Canadian-based multinational clients and deliver services to other multinational clients of the HSBC Group. Our ability to leverage the HSBC Group's worldwide network in providing comprehensive corporate and investment banking services to sophisticated multinational clients is a significant competitive advantage.

*Selected Financial Information and Analysis*. The following sets out consolidated financial information and other data for CIBM:

| | **2003** | 2002 |
|---|---|---|
| Net interest income | **$ 142** | $ 134 |
| Other income | **94** | 103 |
| Total revenues | **236** | 237 |
| Provision for credit losses | **(4)** | (70) |
| Non-interest expenses | **(49)** | (94) |
| Net income before the under noted | **183** | 73 |
| Provision for income taxes | **(69)** | (28) |
| Non-controlling interest in income of trust | **(3)** | (3) |
| Net income | **$ 111** | $ 42 |
| Average assets | **$ 10,352** | $ 10,034 |

Net interest income increased in 2003 compared to 2002 mainly from repositioning the balance sheet to take advantage of the impact of the positive yield curve in the earlier part of the year, as well as anticipating the fall in interest rates during the year.

We recorded significantly lower provisions for credit losses in 2003 resulting from a significant provision made in 2002 for an exposure in the Canadian telecommunications sector.

In 2003 we recorded increased revenues from our foreign exchange trading activities due to strengthening of the Canadian dollar and we also benefited from higher corporate finance fees. This was offset by lower revenues from institutional equity trading as a result of a restructuring in 2002, when we also recognized income of $17 million on the sale of our Toronto Stock Exchange shares.

Non-interest expenses were lower in 2003 largely due to a charge for restructuring of the institutional equities business and provision for rationalizing of vacant space in 2002.

# Statement of Management's Responsibility for Consolidated Financial Statements

The accompanying consolidated financial statements of HSBC Bank Canada (the "Bank") have been prepared by, and are the responsibility of, the Bank's management. The presentation and information provided therein have been prepared in accordance with Canadian generally accepted accounting principles. The consolidated financial statements necessarily include amounts based on informed judgements and estimates of the expected effects of current events and transactions with appropriate consideration to materiality.

In meeting its responsibility for the reliability of financial information, management relies on comprehensive internal accounting, operating and system controls. The Bank's overall controls include an organizational structure providing for effective segregation of responsibilities, delegation of authority and personal accountability; written communication of policies and procedures of corporate conduct throughout the Bank and careful selection and training of personnel; the regular updating and application of written accounting and administrative policies and procedures necessary to ensure adequate internal control over transactions, assets and records; as well as a continued program of extensive internal audit covering all aspects of the Bank's operations. These controls are designed to provide reasonable assurance that financial records are reliable for preparing the consolidated financial statements and maintaining accountability for assets, that assets are safeguarded against unauthorized use or disposition and that the Bank is in compliance with all regulatory requirements.

The Superintendent of Financial Institutions Canada ("the Superintendent"), at least once a year, makes such examination and enquiry into the affairs of the Bank as he feels necessary to satisfy himself that the provisions of the Bank Act, having reference to the safety of the deposits and the parent of the Bank, are being duly observed and that the Bank is in a sound financial position.

The Board of Directors oversees management's responsibilities for the consolidated financial statements through the Audit Committee, which is composed solely of directors who are not officers or employees of the Bank. The Audit Committee meets four times per year at a minimum. Each year it reviews the adequacy of internal controls and discusses with the internal and external auditors the overall scope, timing and specific plans for their respective audits. The Audit Committee reviews with management and the Shareholders' auditors the content and format of the Bank's consolidated financial statements. As part of this process it reviews the adoption of and changes in accounting principles and practices that have a material effect on the Bank's consolidated financial statements and key management estimates and judgements material to those statements. The Audit Committee also considers, for review by the Board and approval by HSBC Holdings plc, the engagement or re-appointment of the Shareholders' auditors.

The Shareholders' auditors, the Bank's Senior Vice-President and Chief Auditor, and the Superintendent have full and free access to the Audit Committee to discuss audit, financial reporting and related matters.

Lindsay Gordon
*President and Chief Executive Officer*

Graham A. McIsaac, CA
*Chief Financial Officer*

January 23, 2004
Vancouver, Canada

# Auditors' Report

## To the Shareholders of HSBC Bank Canada

We have audited the consolidated balance sheets of HSBC Bank Canada as at December 31, 2003 and 2002 and the consolidated statements of income, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Bank as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP
*Chartered Accountants*

January 23, 2004
Vancouver, Canada

## Consolidated Balance Sheets

As at December 31 *(in millions of dollars)*

| | 2003 | 2002 |
|---|---|---|
| **Assets** | | |
| Cash resources: | | |
| Cash and deposits with Bank of Canada | $ **256** | $ 417 |
| Deposits with regulated financial institutions | **3,373** | 3,317 |
| | **3,629** | 3,734 |
| Securities: (note 2) | | |
| Investment | **2,234** | 2,875 |
| Trading | **642** | 870 |
| | **2,876** | 3,745 |
| Securities purchased under reverse repurchase agreements | **1,572** | 416 |
| Loans: (notes 3 & 4) | | |
| Businesses and governments | **11,664** | 11,949 |
| Residential mortgage | **10,880** | 9,809 |
| Consumer | **2,702** | 2,422 |
| Allowance for credit losses | **(313)** | (311) |
| | **24,933** | 23,869 |
| Other: | | |
| Customers' liability under acceptances | **3,247** | 2,374 |
| Land, buildings and equipment (note 5) | **111** | 111 |
| Other assets (note 6) | **1,141** | 940 |
| | **4,499** | 3,425 |
| | $ **37,509** | $ 35,189 |

*Guarantees, commitments and contingent liabilities (note 15)*

*See notes to consolidated financial statements*

| | 2003 | 2002 |
|---|---|---|
| **Liabilities and Shareholders' Equity** | | |
| Deposits: (note 7) | | |
| Regulated financial institutions | $ **641** | $ 758 |
| Individuals | **13,924** | 14,432 |
| Businesses and governments | **14,774** | 13,182 |
| | **29,339** | 28,372 |
| Other: | | |
| Acceptances | **3,247** | 2,374 |
| Securities sold under repurchase agreements | **30** | 28 |
| Other liabilities (note 8) | **2,340** | 1,984 |
| Non-controlling interest in trust and subsidiary (note 9) | **230** | 230 |
| | **5,847** | 4,616 |
| Subordinated debentures (note 10) | **504** | 528 |
| Shareholders' equity: | | |
| Capital stock (note 11) | | |
| Preferred | **125** | 125 |
| Common | **950** | 950 |
| Contributed surplus | **169** | 165 |
| Retained earnings | **575** | 433 |
| | **1,819** | 1,673 |
| | $ **37,509** | $ 35,189 |

Approved by the Board:

William F. Aldinger
*Chairman of the Board*

Lindsay Gordon
*President and Chief Executive Officer*

## Consolidated Statements of Income

For the years ended December 31 *(in millions of dollars except per share amounts)*

| | 2003 | 2002 |
|---|---|---|
| Interest and dividend income: | | |
| Loans | $ 1,375 | $ 1,270 |
| Securities | 105 | 110 |
| Deposits with regulated financial institutions | 54 | 75 |
| Total interest and dividend income | 1,534 | 1,455 |
| Interest expense: | | |
| Deposits | 632 | 564 |
| Debentures | 35 | 35 |
| Total interest expense | 667 | 599 |
| Net interest income | 867 | 856 |
| Provision for credit losses (note 4) | 61 | 127 |
| Net interest income after provision for credit losses | 806 | 729 |
| Other income: | | |
| Deposit and payment service fees | 80 | 75 |
| Credit fees | 69 | 60 |
| Capital market fees | 93 | 69 |
| Mutual fund and administration fees | 53 | 58 |
| Foreign exchange | 61 | 53 |
| Trade finance | 26 | 27 |
| Trading revenue | 9 | 14 |
| Securitization income | 26 | 19 |
| Insurance underwriting, net of claims | 19 | 15 |
| Other | 27 | 51 |
| | 463 | 441 |
| Net interest and other income | 1,269 | 1,170 |
| Non-interest expenses: | | |
| Salaries and employee benefits | 388 | 339 |
| Premises and equipment, including amortization | 109 | 107 |
| Other | 267 | 254 |
| Restructuring | – | 30 |
| Total non-interest expenses | 764 | 730 |
| Income before provision for income taxes and non-controlling interest in income of trust | 505 | 440 |
| Provision for income taxes (note 14) | 189 | 164 |
| Non-controlling interest in income of trust | 16 | 16 |
| Net income | $ 300 | $ 260 |
| Preferred share dividends | 8 | 8 |
| Net income applicable to common shares | $ 292 | $ 252 |
| Average number of common shares outstanding (000's) | 471,168 | 458,675 |
| Basic earnings per common share | $ 0.62 | $ 0.55 |

*See notes to consolidated financial statements*

# Consolidated Statements of Changes in Shareholders' Equity

For the years ended December 31 *(in millions of dollars)*

| | 2003 | 2002 |
|---|---|---|
| Preferred shares: (note 11) | | |
| Balance at beginning and end of year | **$ 125** | $ 125 |
| Common shares: (note 11) | | |
| Balance at beginning of year | **950** | 935 |
| Issued | **–** | 15 |
| Balance at end of year | **950** | 950 |
| Contributed surplus: | | |
| Balance at beginning of year | **165** | 165 |
| Stock-based compensation (note 12) | **4** | – |
| Balance at end of year | **169** | 165 |
| Retained earnings: | | |
| Balance at beginning of year | **433** | 400 |
| Net income | **300** | 260 |
| Acquisition of subsidiary (note 20) | **–** | (19) |
| Preferred share dividends | **(8)** | (8) |
| Common share dividends | **(150)** | (200) |
| Balance at end of year | **575** | 433 |
| Total shareholders' equity | **$ 1,819** | $ 1,673 |

*See notes to consolidated financial statements*

## Consolidated Statements of Cash Flows

For the years ended December 31 *(in millions of dollars)*

| | 2003 | 2002 |
|---|---|---|
| Cash flows provided by (used in) operating activities: | | |
| Net income | $ 300 | $ 260 |
| Adjustments to net income to determine net cash provided by (used in) operating activities: | | |
| Amortization | 36 | 33 |
| Provision for credit losses (note 4) | 61 | 127 |
| Future income taxes (note 14) | (13) | (15) |
| Net accrued interest receivable and payable | 38 | (51) |
| Trading securities | 228 | 407 |
| Other, net | 102 | 227 |
| | 752 | 988 |
| Cash flows provided by (used in) financing activities: | | |
| Deposits received | 967 | 2,056 |
| Securities sold under repurchase agreements | 2 | 21 |
| Proceeds from debentures issued | – | 100 |
| Subordinated debenture redemptions and repayments | – | (71) |
| Dividends paid | (158) | (208) |
| | 811 | 1,898 |
| Cash flows provided by (used in) investing activities: | | |
| Loans funded, excluding securitizations | (1,797) | (2,968) |
| Proceeds from loans securitized | 673 | 464 |
| Investment securities sold (acquired) | 641 | (401) |
| Securities (purchased) sold under reverse repurchase agreements | (1,156) | 12 |
| Net change in non-operating deposits with regulated financial institutions(1) | (83) | 492 |
| Cash and cash equivalents at date of acquisition of business (note 20) | – | 48 |
| Proceeds from sale of net assets (note 21): | – | 22 |
| Less cash and cash equivalents at date of sale | – | (47) |
| Acquisition of land, buildings and equipment | (29) | (9) |
| | (1,751) | (2,387) |
| Increase in cash and cash equivalents | (188) | 499 |
| Cash and cash equivalents, beginning of year | 3,637 | 3,138 |
| Cash and cash equivalents, end of year | $ 3,449 | $ 3,637 |
| Represented by: | | |
| Cash resources per consolidated balance sheet | $ 3,629 | $ 3,734 |
| Less non-operating deposits with regulated financial institutions(1) | (180) | (97) |
| Cash and cash equivalents, end of year | $ 3,449 | $ 3,637 |
| Supplementary cash flow information: | | |
| Interest paid during the year | $ 632 | $ 655 |
| Income taxes paid during the year | $ 210 | $ 179 |

(1) *Non-operating deposits are comprised primarily of cash which reprices after 90 days and cash restricted for recourse on securitization transactions.*

*See notes to consolidated financial statements.*

# Notes to Consolidated Financial Statements

December 31, 2003 and 2002 *(all tabular amounts are in millions of dollars unless stated otherwise)*

HSBC Bank Canada (the Bank) is a subsidiary of HSBC Holdings plc (the Parent). In these consolidated financial statements, Group means the Parent and its subsidiary companies.

## 1 Accounting policies

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP). Certain prior period amounts have been reclassified to conform with the current year presentation. The significant accounting policies used in the preparation of these consolidated financial statements are summarized below.

**a.** *Basis of consolidation*

The assets and liabilities and results of operations of the Bank and its subsidiaries are reported in the financial statements on a consolidated basis. All material intercompany transactions have been eliminated.

**b.** *Use of estimates in preparation of consolidated financial statements*

The preparation of the consolidated financial statements of the Bank requires management to make estimates and assumptions based on information available as of the date of the consolidated financial statements. Therefore, actual results could differ from those estimates.

**c.** *Deposits with regulated financial institutions*

Deposits with regulated financial institutions are recorded at cost. Interest income on interest earning deposits is recorded on an accrual basis.

**d.** *Securities*

Investment account securities, where the Bank's intention is to hold the securities to maturity or until market conditions render alternative investments more attractive, are carried at cost or amortized cost. If the securities held for investment account experience a decline in value that is other than temporary, the carrying value is appropriately reduced. The amortization of premiums and discounts and adjustments to the carrying value of debt securities are included in interest income. Gains and losses on the disposal of securities are included in other income.

Trading account securities, which are purchased for resale over a short period of time, are carried at market value. Gains and losses on disposal or revaluation are included in other income.

Loan substitute securities are customer financings structured as after-tax investments to provide the borrower with an interest rate advantage over what would otherwise be applicable on a conventional loan. Such securities are accorded the accounting treatment applicable to loans.

**e.** *Loans*

Loans are stated net of any unearned income, unamortized premiums or discounts and an appropriate allowance for credit losses.

Interest income is recorded on the accrual basis unless the loan is classified as an impaired loan. Loans are considered to be impaired whenever there is no longer reasonable assurance as to the ultimate collectibility of some portion of principal or interest. Loans where interest is due and has not been collected for a period of 90 days are automatically recognized as impaired, unless management determines there is no reasonable doubt as to the ultimate collectibility of principal and interest. Loans where interest is due and has not been collected for a period of 180 days are automatically classified as impaired.

Impaired loans are recorded at their estimated realizable amounts. This is determined by discounting the expected future cash flows at the effective interest rate inherent in the loans. When the amounts and timing of future cash flows cannot be estimated with reasonable reliability, they are measured at the fair value of any security underlying the loans, net of expected costs of realization. When a loan is classified as impaired, recognition of interest in accordance with the terms of the original loan agreement ceases. Subsequent payments (interest or principal) received on an impaired loan are recorded as a reduction of the recorded investment in the loan. Interest income is recognized only when all allowances for credit losses have been reversed.

Fees associated with lending activities are deferred and amortized over the term of the loans, and are included in income from loans.

# Notes to Consolidated Financial Statements (continued)

## 1 Accounting policies *(continued)*

**f.** *Direct finance leases*

Direct finance leases are included in loans to Businesses and Governments. Initial direct costs of direct finance leases are expensed as incurred. The investment in the lease is defined as the minimum lease payments receivable, including the purchase option price, less unearned income.

**g.** *Allowance for credit losses*

The Bank maintains an allowance for credit losses which is considered adequate to absorb all estimated credit related losses in its portfolio of both on and off-balance sheet items, including deposits with other regulated financial institutions, loan substitute securities, loans, acceptances, derivative instruments and other credit-related contingent liabilities, such as letters of credit and guarantees.

Assessing the adequacy of the allowance for credit losses is inherently subjective as it requires making estimates, including the amount and timing of expected future cash flows, that may be susceptible to significant change.

Specific allowances are recorded on a loan-by-loan basis, for those loans where management believes the ultimate collectibility of all or some portion of principal or interest is in doubt, to reduce the carrying value of an impaired asset to its estimated net realizable amount. The level of specific allowances are determined on an individual asset basis for all commercial loans and some personal loans while a formula approach is utilized for personal loans with similar characteristics. The determination of specific allowances is the responsibility of a dedicated unit that is independent of both the credit approval and credit line functions.

A number of methods are used in determining specific allowances including discounted value of future cash flows, observable market values or the fair values of the underlying security.

General allowances are allowances for losses which management estimates have occurred at the balance sheet date in the portfolio relating to loans within portfolios which give rise to credit risk but are not yet identified as non-performing loans and requiring specific provisions. In determining an appropriate level of general allowances, the Bank has adopted a methodology that incorporates the loan loss history as the basis for determining probability of default and loss given default rates for various credit portfolios that exhibit similar loan loss characteristics. These historic rates are further refined to allow for the stage of the credit cycle and the inherent difficulties in determining whether data collection captures a complete economic cycle. These loss ratios can then be applied to outstanding credit exposures to determine an appropriate level of allowance. Some credit portfolios do not readily lend themselves to this approach and therefore management have estimated an allowance level for these portfolios based on externally published default data or other underlying assumptions made as to the loan loss characteristics of these portfolios.

The provision for credit losses is charged to income and comprises the amounts written off during the year, net of recoveries on amounts written off in prior years, and changes in provisions.

**h.** *Securities purchased and sold under repurchase agreements*

Where securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in respect of the consideration received.

Conversely, securities purchased under analogous commitments to resell are not recognized on the balance sheet and an asset is recorded representing the consideration paid.

**i.** *Land, buildings and equipment*

Land is carried at cost. Buildings, leasehold improvements and equipment are carried at cost, less accumulated amortization. Amortization is calculated using the straight-line method over the estimated useful life of the related asset as follows: buildings – 20 to 40 years, equipment – three to five years, and leasehold improvements – ten to 15 years.

**j.** *Goodwill and other intangible assets*

Goodwill represents the excess price paid for the acquisition of subsidiaries over the fair value of the net assets acquired and is recorded in other assets.

Identifiable, reliably measured other intangible assets resulting from acquisition of subsidiaries are also recorded in other assets. Intangible assets with definite lives are amortized over the estimated period of benefit, not exceeding 15 years, except where a writedown is required to reflect impairment that is other than temporary.

**j.** *Goodwill and other intangible assets (continued)*

Goodwill and other intangible assets are tested at least annually for impairment to ensure that their fair value is greater than or equal to book value. Any excess of book value over fair value is charged to income in the period in which impairment is determined.

**k.** *Acceptances*

The Bank's potential liability under acceptances is reported as a liability. The Bank has equal and offsetting claims against its customers, which are reported as an asset in the event of a call on these commitments. Fees earned are reported in other income.

**l.** *Income taxes*

The Bank follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and future income tax liabilities are determined based on temporary differences (differences between the tax basis and accounting basis of assets and liabilities) and are measured using the enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability is settled. A valuation allowance is recorded against any future tax asset if it is more likely than not that the asset will not be realized. Income tax expense or benefit is the sum of the provision for current income taxes and the difference between the opening and ending balances of the future income tax assets and liabilities.

**m.** *Employee future benefits*

The Bank sponsors a number of pension plans and arrangements covering all qualified employees. The pension plans include both defined benefit and defined contribution plans. The arrangements include supplemental pension arrangements, that provide pension benefits in excess of the benefits provided by the pension plans, and post-retirement, non-pension arrangements that provide certain benefits in retirement. The pension plans are funded by contributions from the Bank or employees, while the other arrangements are not funded.

The costs of employee future benefits for defined benefits plans are determined using the projected unit credit method prorata on service and using management's best estimate of expected investment performance, salary escalation and expected health care costs.

For purposes of determining the expected return on pension plan assets, those assets are valued at their fair market value.

The excess of cumulative unrecognized net actuarial gains or losses over 10% of the greater of the accrued benefit obligation and the fair market value of plan assets is amortized over the expected average remaining service lifetimes ("EARSL") of active employees covered under the plan in question.

Past service costs arising from retroactive benefit improvements are amortized on a straight-line basis over the EARSL of active members expected to receive benefits under the plan in question.

The transitional asset arising from adoption of a change in accounting policy in earlier years is amortized over the expected future service lifetime of the active employees.

For the purposes of determining the financial position and the costs of employee future benefits, a measurement date of September 30 has been adopted.

**n.** *Translation of foreign currencies*

Assets and liabilities in foreign currencies are translated into Canadian dollars at year-end spot exchange rates. Revenues and expenses in foreign currencies are translated into Canadian dollars at the rates in effect at the transaction date. Premiums and discounts on foreign currency forward contracts that hedge foreign currency assets and liabilities are amortized over the period to maturity as interest expense in the consolidated statement of income. Realized and unrealized gains and losses from foreign currency translation are included in other income in the consolidated statements of income.

# Notes to Consolidated Financial Statements (continued)

## 1 Accounting policies *(continued)*

**o.** *Derivative instruments*

The Bank enters into interest rate, foreign exchange and equity derivative contracts in the normal course of business.

Trading derivatives are undertaken for proprietary trading, market making and to assist customers in managing their exposures. Trading derivatives are marked to market on a daily basis and the resulting gains and losses are recorded in other income. The unrealized portion of the gains and losses on trading derivatives is recorded in other assets or other liabilities as appropriate.

Asset/liability management ("ALM") derivatives are used to manage financial risks in the banking book such as movements in interest rates and foreign currency exchange rates. These derivatives are used to transfer these financial risks or to modify assets or liabilities or groups of similar on-balance sheet assets or liabilities. These contracts are accounted for on an accrual basis whereby the income or expense is recognized over the term of the agreement as an adjustment to interest revenue or expense. Accrued interest receivable and payable and deferred gains and losses are recorded in other assets or other liabilities as appropriate.

**p.** *Trust assets under administration*

Trust assets under administration are maintained separately from the Bank's assets and are not included in the consolidated balance sheets.

**q.** *Loan securitizations*

The Bank periodically sells groups of loans to unrelated third parties. Transfers of loans are treated as sales provided that control over the transferred loans has been surrendered and consideration other than beneficial interests in the transferred loans has been received in exchange. If treated as sales, the loans are removed from the balance sheet and a gain or loss is recorded in other income based on the carrying value of the loans transferred, allocated between the assets sold and their retained interests in proportion to their fair values at the date of transfer.

The fair values of loans sold, retained interests and recourse liabilities are determined using market values where appropriate or pricing models taking into account management's best estimates of key assumptions such as expected losses, prepayments and discount rates commensurate with the risks involved, or sales of similar assets. Retained interests, which are accounted for as investment securities, are included in other assets. Where the Bank continues to service the loans sold, a servicing liability or asset is recognized and amortized over the servicing period.

Revenue earned by the Bank in respect of servicing the assets sold is reflected in other income as services are provided.

**r.** *Stock-based compensation and other stock-based payments*

Effective January 1, 2003 the Bank prospectively adopted amendments to CICA Handbook Section 3870 "Stock-Based Compensation and Other Stock-Based Payments", in respect of awards granted to employees during 2003. Under the amendments to this standard, all stock-based compensation arrangements are accounted for using a fair value based method. In 2002 the Bank applied certain exemptions available at that time to the relevant share compensation schemes in respect of awards that were neither direct grants of stock nor awards that called for the settlement in cash, other assets or net equity.

**s.** *Changes in accounting polices*

*Stock-based compensation*

Effective January 1, 2003, the Bank adopted certain new provisions of the existing accounting standard on stock-based compensation (see note 1(r)).

*Disclosure of guarantees*

Effective January 1, 2003, the Bank prospectively adopted the new accounting guideline on disclosure of guarantees. The guideline stipulates the financial statement disclosures to be made by a guarantor about its obligations under certain guarantees, as detailed in note 15.

*Impaired loans and impairment of long lived assets*

The Bank has adopted the new accounting standards related to impaired loans and impairment of long lived assets, however, these new standards do not have a material effect on the Bank's consolidated financial statements.

## 1 Accounting policies *(continued)*

**t.** *Future accounting changes*

*Hedging*

The CICA has issued an accounting guideline for hedging relationships that will become effective for fiscal year 2004. This guideline establishes certain requirements for the application of hedge accounting including detailed guidance on the identification, designation, documentation and effectiveness of hedging relationships, for purposes of applying hedge accounting; and guidance on the discontinuance of hedge accounting. Subsequent to January 1, 2004 changes in the fair value of derivatives that do not qualify for hedge accounting will be recorded in income. The impact of implementing this guideline on the Bank's future results will depend on the Bank's hedging strategies and market volatility. In planning its implementation, the Bank has ascertained that all items currently designated as hedges qualify for hedge accounting under the new guideline.

*Liabilities and equity*

The Accounting Standards Board ("AcSB") has issued an exposure draft amending CICA Handbook section 3860 that would require obligations that could be settled with an entity's own equity instruments, at the issuer's option, to be reflected as a liability when the number of instruments to be issued varies with their fair value so that the total number to be issued is always equal to the contractual amount of the obligation. This is not expected to have a material impact on the Bank's consolidated financial statements.

*Consolidation of variable interest entities*

The AcSB has issued an accounting guideline requiring the consolidation of certain variable interest entities ("VIE"). For VIE that do not meet specified exemption criteria, consolidation is required based upon either voting rights or a determination of the identity of the VIE primary beneficiary. It is anticipated that this guideline will be amended so as to harmonize with an amended standard recently issued by the United States Financial Accounting Standards Board, and will become effective January 1, 2005. The impact of this guideline on the Bank has not been determined.

Based on a preliminary assessment, a summary of the principal items that could be impacted by the guideline include Bank-originated assets, mutual funds, innovative capital structures, personal trusts and investment vehicles.

This is not expected to have a material impact on the Bank's consolidated financial statements.

*Accounting for financial instruments*

The AcSB has issued three exposure drafts effective for fiscal years commencing on or after October 1, 2005, Financial Instruments – Recognition and Measurement, Hedges and Comprehensive Income. If adopted as drafted, a number of changes in accounting for derivatives and certain other financial instruments is likely. These exposure drafts propose that all derivatives and other financial instruments be included on an entity's balance sheet and measured generally at their fair values.

Securities that are bought and held principally for the purpose of trading would be classified as trading securities and reported at fair value, with unrealized gains and losses included in net income. Securities that the Bank intends to hold to maturity would be classified as held-to-maturity securities and reported at amortized cost. This is no change from existing practice, but there would be a number of so-called "tainting" rules intended to ensure that classifications cannot be changed, without facing considerable restrictions on future asset classification.

The remaining securities would be classified as available-for-sale securities and reported at fair value, with unrealized gains and losses temporarily recorded in a separate new component of shareholders' equity, "Other Comprehensive Income."

There would be an extension of existing requirements for hedge accounting. Currently there are requirements in place that specify the circumstances under which hedge accounting is permissible. The new proposals provide comprehensive accounting requirements for hedges including the need to mark to market any derivatives that do not meet certain stringent hedging criteria.

The Bank has not yet evaluated the detailed proposals. However, there may be inter-period volatility of the Bank's net income resulting from derivatives that would no longer qualify for hedge accounting treatment.

# Notes to Consolidated Financial Statements (continued)

## 1 Accounting policies *(continued)*

**t.** *Future accounting changes (continued)*

*Generally accepted accounting principles*

The CICA has issued guidance which establishes standards for financial reporting in accordance with generally accepted accounting principles effective for fiscal 2004. It describes what constitutes Canadian generally accepted accounting principles and its sources. Guidance is provided on sources to consult ("GAAP hierarchy") when selecting accounting polices and determining appropriate disclosures, when a matter is not dealt with explicitly in primary sources of GAAP.

The Bank is assessing the impact of this guidance.

## 2 Securities

a *Carrying value*

**2003**

| | Term to maturity: Within 1 year | 1-5 years | 5-10 years | No specific maturity | Total carrying value |
|---|---|---|---|---|---|
| **Investment securities:** | | | | | |
| Securities issued or guaranteed by: | | | | | |
| Canada | $ 1,717 | $ 212 | $ 2 | $ – | $ 1,931 |
| Provinces | 197 | 8 | 12 | – | 217 |
| | 1,914 | 220 | 14 | – | 2,148 |
| Others | 4 | 23 | – | 4 | 31 |
| Mutual funds | – | – | – | 41 | 41 |
| Equity securities | 6 | 8 | – | – | 14 |
| **Total investment securities** | 1,924 | 251 | 14 | 45 | 2,234 |
| **Trading securities** | 397 | 218 | 4 | 23 | 642 |
| **Total securities** | $ 2,321 | $ 469 | $ 18 | $ 68 | $ 2,876 |

2002

| | Term to maturity: Within 1 year | 1-5 years | 5-10 years | No specific maturity | Total carrying value |
|---|---|---|---|---|---|
| **Investment securities:** | | | | | |
| Securities issued or guaranteed by: | | | | | |
| Canada | $ 1,982 | $ 503 | $ – | $ – | $ 2,485 |
| Provinces | 282 | 11 | 13 | – | 306 |
| | 2,264 | 514 | 13 | – | 2,791 |
| Others | 2 | 7 | 2 | – | 11 |
| Mutual funds | – | – | – | 24 | 24 |
| Equity securities | 9 | 6 | 9 | 5 | 29 |
| **Total investment securities** | 2,275 | 527 | 24 | 29 | 2,855 |
| **Loan substitute securities** | 20 | – | – | – | 20 |
| **Trading securities** | 524 | 19 | 47 | 280 | 870 |
| **Total securities** | $ 2,819 | $ 546 | $ 71 | $ 309 | $ 3,745 |

Included in trading securities are $400 million of securities issued or guaranteed by Canada or Provinces (2002 - $414 million).

The total carrying value of securities includes amounts denominated in U.S. dollars of $299 million (Canadian equivalent) (2002 - $561 million).

## 2 Securities *(continued)*

**b** *Unrealized gains and losses on investment securities*

| | 2003 | | | |
|---|---|---|---|---|
| | *Carrying value* | *Gross unrealized gains* | *Gross unrealized losses* | *Estimated market value* |
| Securities issued or guaranteed by: | | | | |
| Canada | $ **1,931** | $ **14** | $ – | $ **1,945** |
| Provinces | **217** | **2** | – | **219** |
| | **2,148** | **16** | – | **2,164** |
| Others | **31** | – | – | **31** |
| Mutual funds | **41** | **13** | – | **54** |
| Equity securities | **14** | – | – | **14** |
| **Total investment securities** | $ **2,234** | $ **29** | $ – | $ **2,263** |

| | 2002 | | | |
|---|---|---|---|---|
| | *Carrying value* | *Gross unrealized gains* | *Gross unrealized losses* | *Estimated market value* |
| Securities issued or guaranteed by: | | | | |
| Canada | $ 2,485 | $ 23 | $ – | $ 2,508 |
| Provinces | 306 | 1 | – | 307 |
| | 2,791 | 24 | – | 2,815 |
| Others | 11 | – | – | 11 |
| Mutual funds | 24 | 8 | (1) | 31 |
| Equity securities | 29 | – | (1) | 28 |
| **Total investment securities** | $ 2,855 | $ 32 | $ (2) | $ 2,885 |

## 3 Loans

**a** The Bank's loans outstanding, net of the allowance for credit losses, are as follows:

| | **2003** | 2002 |
|---|---|---|
| Businesses and governments: | | |
| Real estate | $ **3,489** | $ 3,687 |
| Hotels and hospitality | **624** | 675 |
| Manufacturing | **1,687** | 1,667 |
| Trade | **2,912** | 2,949 |
| Services | **1,910** | 1,723 |
| Direct finance leases | **700** | 606 |
| Other | **342** | 642 |
| Total businesses and governments | **11,664** | 11,949 |
| Residential mortgages | **10,880** | 9,809 |
| Consumer | **2,702** | 2,422 |
| Allowance for credit losses | **(313)** | (311) |
| Total | $ **24,933** | $ 23,869 |

Total net loans includes amounts denominated in U.S. dollars of $1,125 million (Canadian equivalent) (2002 - $1,231 million) and other foreign currencies of $38 million (Canadian equivalent) (2002 - $133 million). Included in residential mortgages are $953 million of CMHC insured mortgages (2002 - $972 million).

# Notes to Consolidated Financial Statements (continued)

## 3 Loans *(continued)*

**b** The outstanding securitized loans sold to unrelated third parties and removed from the balance sheet are as follows:

| | **2003** | 2002 |
|---|---|---|
| Residential mortgages | | |
| Conventional | **$ 45** | $ 182 |
| Mortgage-backed securities | **658** | 511 |
| | **703** | 693 |
| Consumer loans | | |
| Personal lines of credit | **$ 300** | $ – |
| Terms loans | **114** | 428 |
| | **414** | 428 |
| | **$ 1,117** | $ 1,121 |

Securitization activity during the year is as follows:

| | **2003** | | | | 2002 | | | |
|---|---|---|---|---|---|---|---|---|
| | *Residential mortgages* | *Personal lines of credit* | *Consumer term loans* | *Total* | *Residential mortgages* | *Personal lines of credit* | *Consumer term loans* | *Total* |
| **New securitization activity** | | | | | | | | |
| Securitized and sold | **$ 375** | **$ 300** | **$ –** | **$ 675** | $ 268 | $ – | $ 200 | $ 468 |
| Net cash proceeds received | **373** | **300** | **–** | **673** | 267 | – | 197 | 464 |
| Retained rights to future excess interest | **12** | **27** | **–** | **39** | 7 | – | 10 | 17 |
| Retained servicing liability | **3** | **7** | **–** | **10** | 2 | – | 1 | 3 |
| Pre-tax gain on sale | **5** | **11** | **–** | **16** | 3 | – | 9 | 12 |
| **Key assumptions at time of sale** | | | | | | | | |
| Prepayment rate | **14.40%** | **–** | **–** | | 14.40% | – | 4.50% | |
| Excess spread | **1.20%** | **2.15%** | **–** | | 1.20% | – | 4.00% | |
| Expected credit losses | **–** | **1.47%** | **–** | | – | – | – | |
| Discount rate | **5.20%** | **4.03%** | **–** | | 5.80% | – | 4.00% | |

Servicing fee income from securitized assets was $3 million during the year (2002 - $2 million). No delinquent securitized mortgages were repurchased by the Bank during the year (2002 - $2 million) and credit losses of $1 million were realized on securitized consumer loans (2002 - $1 million).

## 4 Impaired loans and allowance for credit losses

**a** The Bank's total gross impaired loans and the related specific allowances are as follows:

| | **2003** | | | 2002 | | |
|---|---|---|---|---|---|---|
| | *Gross amount* | *Specific allowances* | *Carrying amount* | *Gross amount* | *Specific allowances* | *Carrying amount* |
| Businesses and governments | | | | | | |
| Real estate | **$ 55** | **$ 6** | **$ 49** | $ 53 | $ 11 | $ 42 |
| Manufacturing | **36** | **10** | **26** | 38 | 17 | 21 |
| Trade | **20** | **7** | **13** | 26 | 12 | 14 |
| Services | **8** | **5** | **3** | 8 | 5 | 3 |
| Other | **47** | **18** | **29** | 59 | 26 | 33 |
| Consumer | **14** | **8** | **6** | 16 | 8 | 8 |
| Residential mortgages | **23** | **1** | **22** | 25 | 1 | 24 |
| Total | **$ 203** | **$ 55** | **$ 148** | $ 225 | $ 80 | $ 145 |

**b** The Bank's allowance for credit losses is as follows:

| | **2003** | | | | |
|---|---|---|---|---|---|
| | *Balance at beginning of the year* | *Provision for credit losses* | *Write-offs* | *Recoveries and other* | *Balance at end of the year* |
| Specific allowances: | | | | | |
| Businesses and governments: | | | | | |
| Real estate | **$ 11** | **$ 2** | **$ (7)** | **$ –** | **$ 6** |
| Manufacturing | **17** | **6** | **(12)** | **(1)** | **10** |
| Trade | **12** | **1** | **(5)** | **(1)** | **7** |
| Services | **5** | **2** | **(2)** | **–** | **5** |
| Other | **26** | **15** | **(21)** | **(2)** | **18** |
| Consumer | **8** | **10** | **(10)** | **–** | **8** |
| Residential mortgages | **1** | **1** | **(1)** | **–** | **1** |
| Total specific allowances | **80** | **37** | **(58)** | **(4)** | **55** |
| General allowance | **231** | **24** | **–** | **3** | **258** |
| Total | **$ 311** | **$ 61** | **$ (58)** | **$ (1)** | **$ 313** |

| | 2002 | | | | |
|---|---|---|---|---|---|
| | *Balance at beginning of the year* | *Provision for credit losses* | *Write-offs* | *Recoveries and other* | *Balance at end of the year* |
| Specific allowances: | | | | | |
| Businesses and governments: | | | | | |
| Real estate | $ 10 | $ 4 | $ (2) | $ (1) | $ 11 |
| Manufacturing | 10 | 22 | (16) | 1 | 17 |
| Trade | 15 | 3 | (4) | (2) | 12 |
| Services | 6 | 1 | (1) | (1) | 5 |
| Other | 28 | 95 | (101) | 4 | 26 |
| Consumer | 10 | 8 | (10) | – | 8 |
| Residential mortgages | 1 | 2 | (2) | – | 1 |
| Total specific allowances | 80 | 135 | (136) | 1 | 80 |
| General allowance | 235 | (8) | – | 4 | 231 |
| Total | $ 315 | $ 127 | $ (136) | $ 5 | $ 311 |

# Notes to Consolidated Financial Statements (continued)

## 5 Land, buildings and equipment

| | Cost | Accumulated amortization | Net book value 2003 | Net book value 2002 |
|---|---|---|---|---|
| Land and buildings | $ 24 | $ 4 | **$ 20** | $ 20 |
| Furniture and equipment | 84 | 52 | **32** | 33 |
| Computer equipment | 25 | 19 | **6** | 10 |
| Leasehold improvements | 94 | 41 | **53** | 48 |
| Total | $ 227 | $ 116 | **$ 111** | $ 111 |

Amortization charged to income for the year ended December 31, 2003 amounted to $29 million (2002 - $27 million).

## 6 Other assets

| | 2003 | 2002 |
|---|---|---|
| Accrued interest receivable | **$ 84** | $ 85 |
| Interest earning other assets | **170** | 139 |
| Due from clients, dealers and clearing corporations | **208** | 156 |
| Market revaluation of trading derivatives (note 17) | **356** | 218 |
| Future income taxes, net (note 14) | **123** | 116 |
| Goodwill and other intangible assets, net | **47** | 56 |
| Accounts receivable and other | **153** | 170 |
| Total | **$ 1,141** | $ 940 |

Amortization of intangible assets charged to income for the year ended December 31, 2003 amounted to $9 million (2002 - $8 million).

## 7 Deposits

| | 2003 | | | |
|---|---|---|---|---|
| | Regulated financial institutions | Individuals | Businesses and governments | Total |
| Demand | **$ 102** | **$ –** | **$ 1,518** | **$ 1,620** |
| Notice | **–** | **3,144** | **4,617** | **7,761** |
| Fixed date | **539** | **10,780** | **8,639** | **19,958** |
| Total | **$ 641** | **$ 13,924** | **$ 14,774** | **$ 29,339** |

| | 2002 | | | |
|---|---|---|---|---|
| | Regulated financial institutions | Individuals | Businesses and governments | Total |
| Demand | $ 158 | $ – | $ 1,285 | $ 1,443 |
| Notice | – | 3,018 | 4,012 | 7,030 |
| Fixed date | 600 | 11,414 | 7,885 | 19,899 |
| Total | $ 758 | $ 14,432 | $ 13,182 | $ 28,372 |

Deposits denominated in U.S. dollars amount to $6,712 million (Canadian equivalent) (2002 - $8,049 million) and in other foreign currencies amount to $589 million (Canadian equivalent) (2002 - $653 million).

## 8 Other liabilities

| | | 2003 | | 2002 |
|---|---|---|---|---|
| Accrued interest payable | $ | **192** | $ | 157 |
| Mortgages sold with recourse (note 15) | | **181** | | 160 |
| Interest costing other liabilities | | **489** | | 207 |
| Payable to clients, dealers and clearing corporations | | **272** | | 655 |
| Market revaluation of trading derivatives (note 17) | | **350** | | 213 |
| Accounts payable and other | | **856** | | 592 |
| Total | $ | **2,340** | $ | 1,984 |

## 9 Non-controlling interest in trust and subsidiary

**a** *HSBC Canada Asset Trust*

HSBC Canada Asset Trust (the "Trust") is a closed-end trust established by HSBC Trust Company (Canada), a wholly owned subsidiary of the Bank, as trustee. The Trust's objective is to hold qualifying assets which will generate net income for distribution to holders of securities issued by the Trust. The Trust assets are primarily undivided co-ownership interests in pools of Canada Mortgage and Housing Corporation ("CMHC") insured first mortgages originated by the Bank or its subsidiaries and deposits with the Bank.

The Trust has 200,000 HSBC Canada Asset Trust Securities – Series 2010 ("HaTS™") outstanding which total $200 million. Each of the HaTS was offered at $1,000 to provide an effective annual yield of 7.78% to December 31, 2010 and the six month bankers' acceptance rate plus 2.37% thereafter. Unless the Bank fails to declare dividends on its preferred shares, the Trust will make non-cumulative semi-annual cash distributions to the holders of each of the HaTS.

The Bank has covenanted that if the Trust fails to pay the indicated yield in full on the HaTS, the Bank will not declare dividends on any of its shares unless the Trust first pays the indicated yield (note 11).

The HaTS are not redeemable by the holders. Subject to regulatory approval, the Trust may redeem the HaTS on June 20, 2005 and on any distribution date thereafter.

**b** *HSBC Mortgage Corporation (Canada)*

Group holds $30 million, a 100% interest, of class B perpetual preferred shares issued by HSBC Mortgage Corporation (Canada) ("HMC"), a wholly owned subsidiary of the Bank. No dividends were paid or payable on these perpetual preferred shares for the years ended December 31, 2003 and 2002. Dividends may be declared at the discretion of the directors of HMC.

## 10 Subordinated debentures

Debentures, which are unsecured and subordinated in right of payment to the claims of depositors and certain other creditors, comprise:

| *Interest rate (%)* | *Year of maturity* | *Foreign currency amount* | | 2003 | | 2002 |
|---|---|---|---|---|---|---|
| **Issued to Group companies** | | | | | | |
| 7.09(1) | 2094 | US$85 | $ | **109** | $ | 133 |
| **Issued to others** | | | | | | |
| 11.00(2) | 2005 | | | **60** | | 60 |
| 5.73(3) | 2009 | | | **60** | | 60 |
| 6.79(4) | 2009 | | | **50** | | 50 |
| 7.70(5) | 2011 | | | **60** | | 60 |
| 6.65(6) | 2012 | | | **25** | | 25 |
| 5.60(7) | 2012 | | | **100** | | 100 |
| 30 day bankers' acceptance rate plus 0.50% | 2083 | | | **40** | | 40 |
| | | | | **395** | | 395 |
| Total | | | $ | **504** | $ | 528 |

# Notes to Consolidated Financial Statements (continued)

## 10 Subordinated debentures *(continued)*

(1) *The interest rate is fixed at 7.09% until July 2005 and thereafter the rate reprices every five years at the then five year U.S. Treasury rate plus 0.80%. Interest expense for the year amounted to $9 million (2002 - $9 million).*

(2) *The interest rate is fixed until maturity.*

(3) *The interest rate is fixed at 5.73% until November 2004 and thereafter the rate reprices at the 90 day average bankers' acceptance rate plus 1.00%.*

(4) *The interest rate is fixed at 6.79% until December 2004 and thereafter the rate reprices at the 90 day average bankers' acceptance rate plus 1.00%*

(5) *The interest rate is fixed at 7.70% until February 2006 and thereafter the rate reprices at the 90 day average bankers' acceptance rate plus 1.00%.*

(6) *The interest rate is fixed at 6.65% until September 2007 and thereafter the rate reprices at the 90 day average bankers' acceptance rate plus 1.00%.*

(7) *The interest rate is fixed at 5.60% until June 2007 and thereafter the rate reprices at the 90 day average bankers' acceptance rate plus 1.00%*

## 11 Capital stock

### Authorized:

Preferred – Unlimited number of Class 1 preferred shares in one or more series and unlimited number of Class 2 preferred shares in one or more series. The Board of Directors may from time to time divide any unissued Class 1 preferred shares into series and fix the number of shares in each series and the rights, privileges, restrictions and conditions.

Common – 993,677,000 common shares without par value.

### Issued and fully paid:

| | **2003** | | 2002 | |
|---|---|---|---|---|
| | *Number of shares* | *Amount* | *Number of shares* | *Amount* |
| Preferred – Class 1, Series A[1] | **5,000,000** | **$ 125** | 5,000,000 | $ 125 |
| Common[2] | **471,168,000** | **950** | 471,168,000 | 950 |
| | | **$ 1,075** | | $ 1,075 |

(1) *The shares are non-voting, non-cumulative and redeemable. Each of the shares yield 6.25%, payable quarterly, as and when declared, until September 30, 2005. Subsequently, the dividend rate will be the greater of 6.00% or 95% of the average prime lending rate in Canada for the quarter immediately preceding the month in which the dividend is paid, as and when declared. During 2003, $8 million (2002 - $8 million) in dividends were declared and paid.*

*The shares are not redeemable prior to September 30, 2005. Subject to regulatory approval on September 30, 2005, and on the last day of every successive period for five years and one day thereafter, the shares may be redeemed in whole by the Bank by the payment of cash equal to $25 per share plus all declared and unpaid dividends to the redemption date.*

*On September 30, 2005, and on the last day of every successive period for five years and one day thereafter, holders of shares will have the right to convert such shares into Preferred Shares Series B on a share-for-share basis, provided the Bank has not delivered a notice of redemption in respect of Preferred Shares Series A. The provisions of the Preferred Shares Series B are the same as those for Series A, except that the yield will be set to equal the five year Government of Canada bond rate 21 days preceding the date of conversion.*

(2) *On October 31, 2002, the Bank issued 15 million common shares for $15 million as consideration for the purchase of Merrill Lynch HSBC Canada Inc. (note 20).*

### Dividend restrictions:

The Bank has covenanted that if the Trust fails to pay the indicated yield in full on the HaTS™, the Bank will not declare dividends on any of its shares unless the Trust first pays the indicated yield (note 9).

## 12 Stock-based compensation

The Bank has three plans where shares or options have been awarded. Shares have been awarded to key employees of the Bank under the HSBC Restricted Share Plan. Stock options have been granted to employees of the Bank under the HSBC Holdings Group Share Option Plan (the "Group Share Option Plan") and the HSBC Savings-Related Share Option Scheme (the "Savings-Related Share Option Scheme"). As the shares and awards are in ordinary shares of the Parent, which are traded on the London Stock Exchange, individual share information disclosed below is in Pounds Sterling. As at December 31, 2003 one Pound Sterling was equivalent to $2.31.

In 2003, the Bank prospectively adopted the fair value method for stock-based compensation for awards granted in 2003 and subsequent years. Under this method, the fair value of stock awards granted is amortized as salary and benefits expense over the vesting period.

## 12 Stock-based compensation *(continued)*

Fair values of share options, measured at the date of grant of the option, are estimated using a binomial option pricing model which produces similar results to the Black-Scholes option pricing model. The fair values estimated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used. The significant weighted average assumptions used to estimate the fair value of the options granted in 2003 are as follows:

| | *Group share option plan* | *Savings-related share option scheme - 3 year* | *Savings-related share option scheme - 5 year* |
|---|---|---|---|
| Risk-free interest rate (%) | 4.64 | 4.01 | 4.42 |
| Expected life (years) | 10 | 3.7 | 5.7 |
| Expected volatility (%) | 30 | 30 | 30 |
| Expected dividend (%) | 4.68 | 4.68 | 4.68 |

*Restricted Share Plan*

The Bank provides awards to key employees in the form of restricted shares of the Parent. These awards require achievement of certain performance targets and vest three years from the date of the award. The restricted shares are purchased in the open market and are held in trust on behalf of the employee until vested. The cost of shares charged to income in 2003 was $2 million (2002 - $3 million).

*Group Share Option Plan*

The Group Share Option Plan is a long-term incentive compensation plan available to certain Bank employees with grants usually made each year. Options are granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions.

The fair value of options granted in 2003 was £1.88 (2002 - £1.59) per option.

| | **2003** | | 2002 | |
|---|---|---|---|---|
| | *Number of options* | *Weighted average exercise price* | *Number of options* | *Weighted average exercise price* |
| **Group Share Option Plan** | | | | |
| Options outstanding, beginning of year | **11,635,168** | **£7.48** | 9,493,573 | £7.18 |
| Granted in the year | **2,449,927** | **£6.91** | 2,868,421 | £8.41 |
| Exercised | **(801,914)** | **£5.74** | (626,526) | £5.88 |
| Forfeited/expired | **(366,725)** | **£6.96** | (100,300) | £7.48 |
| Options outstanding, end of year | **12,916,456** | **£7.49** | 11,635,168 | £7.48 |
| Options exercisable, end of year | **5,191,250** | | 4,157,089 | |

| | *Options outstanding* | | | *Options exercisable* | |
|---|---|---|---|---|---|
| *Exercise prices* | *Number outstanding at end of year* | *Weighted average remaining contractual life (years)* | *Weighted average exercise price* | *Number exercisable at end of year* | *Weighted average exercise price* |
| £2.84-£3.33 | 44,250 | 1.86 | £3.24 | 44,250 | £3.24 |
| £5.02-£6.38 | 3,141,400 | 5.12 | £6.33 | 3,141,400 | £6.33 |
| £6.91-£7.80 | 4,606,450 | 7.99 | £7.15 | 2,005,600 | £7.46 |
| £8.13-£8.71 | 5,124,356 | 7.86 | £8.55 | – | – |
| | 12,916,456 | 7.22 | £7.49 | 5,191,250 | £6.74 |

The fair value of share options charged to income in 2003 was $3 million with a corresponding credit to contributed surplus.

## Notes to Consolidated Financial Statements (continued)

### 12 Stock-based compensation *(continued)*

*Savings-Related Share Option Schemes*

The Savings-Related Share Option Schemes invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The options are exercisable within six months following either the third or the fifth anniversary of the commencement of the savings contract depending on conditions set at grant. The exercise price is at a 20 per cent discount to the market value at the date of grant.

| | **2003** | | 2002 | |
|---|---|---|---|---|
| | *Number of options* | *Weighted average exercise price* | *Number of options* | *Weighted average exercise price* |
| **Savings related share option plan – 5 year** | | | | |
| Options outstanding, beginning of year | **2,250,652** | **£5.85** | 2,754,951 | £4.70 |
| Granted in the year | **536,795** | **£5.35** | 164,926 | £6.32 |
| Exercised | **(356,813)** | **£5.23** | (412,638) | £4.49 |
| Forfeited/expired | **(747,114)** | **£6.17** | (256,587) | £5.79 |
| Options outstanding, end of year | **1,683,520** | **£5.69** | 2,250,652 | £5.85 |
| Options exercisable, end of year | **30,900** | | 30,780 | |

| | *Options outstanding* | | | *Options exercisable* | |
|---|---|---|---|---|---|
| *Exercise prices* | *Number outstanding at end of year* | *Weighted average remaining contractual life (years)* | *Weighted average exercise price* | *Number exercisable at end of year* | *Weighted average exercise price* |
| £5.52-£6.03 | 1,557,045 | 1.98 | £5.62 | 30,900 | £5.22 |
| £6.32-£6.75 | 126,475 | 2.63 | £6.61 | – | – |
| | 1,683,520 | 2.03 | £5.69 | 30,900 | £5.22 |

The fair value of options granted in 2003 was £2.05 (2002 - £2.41) per option.

| | **2003** | | 2002 | |
|---|---|---|---|---|
| | *Number of options* | *Weighted average exercise price* | *Number of options* | *Weighted average exercise price* |
| **Savings related share option plan – 3 year** | | | | |
| Options outstanding, beginning of year | **855,555** | **£6.56** | 529,838 | £5.79 |
| Granted in the year | **1,360,567** | **£5.35** | 397,820 | £6.32 |
| Exercised | **(1,670)** | **£6.72** | (2,637) | £6.75 |
| Forfeited/expired | **(524,510)** | **£6.51** | (69,466) | £6.70 |
| Options outstanding, end of year | **1,689,942** | **£5.60** | 855,555 | £6.56 |
| Options exercisable, end of year | – | | – | |

## 12 Stock-based compensation *(continued)*

| | *Options outstanding* | | | *Options exercisable* | |
|---|---|---|---|---|---|
| *Exercise prices* | *Number outstanding at end of year* | *Weighted average remaining contractual life (years)* | *Weighted average exercise price* | *Number exercisable at end of year* | *Weighted average exercise price* |
| £6.75 | 201,904 | 0.28 | £6.75 | – | – |
| £6.32 | 143,313 | 1.33 | £6.32 | – | – |
| £5.35 | 1,344,725 | 2.35 | £5.35 | – | |
| | 1,689,942 | 2.02 | £5.60 | – | – |

The fair value of options granted in 2003 was £2.00 (2002 - £2.48) per option.

The fair value of share options charged to income in 2003, under both savings related schemes, was $1 million with a corresponding credit to contributed surplus.

## 13 Employee future benefits

Information about the defined benefit plans, in aggregate, as at December 31 (using a measurement date of September 30 – see note 1) is as follows:

| | *Pension benefits* | | *Other benefits* | |
|---|---|---|---|---|
| | **2003** | 2002 | **2003** | 2002 |
| **Reconciliation of accrued benefit obligation** | | | | |
| Accrued benefit obligation, beginning of year | **$ 164** | $ 152 | **$ 62** | $ 49 |
| Service cost | **9** | 8 | **5** | 3 |
| Interest cost | **12** | 11 | **5** | 4 |
| Benefits paid | **(9)** | (9) | **(1)** | (1) |
| Plan amendments | **2** | – | **–** | – |
| Actuarial loss | **7** | 1 | **23** | 7 |
| Employee contributions | **1** | 1 | **–** | – |
| Accrued benefit obligation, end of year | **$ 186** | $ 164 | **$ 94** | $ 62 |
| **Reconciliation of fair value of plan assets** | | | | |
| Fair value of plan assets, beginning of year | **$ 145** | $ 154 | **$ –** | $ – |
| Return on plan assets | **16** | (8) | **–** | – |
| Bank contributions | **8** | 7 | **1** | 1 |
| Employee contributions | **1** | 1 | **–** | – |
| Benefits paid | **(9)** | (9) | **(1)** | (1) |
| Fair value of plan assets, end of year | **$ 161** | $ 145 | **$ –** | $ – |
| **Funded status** | | | | |
| Funded status – plan (deficit) | **$ (25)** | $ (19) | **$ (94)** | $ (62) |
| Bank contributions after measurement date | **26** | 2 | **–** | – |
| Unamortized net actuarial loss | **76** | 79 | **30** | 8 |
| Unamortized past service costs | **2** | – | **–** | – |
| Unamortized transitional (asset) obligation | **(45)** | (49) | **30** | 32 |
| Accrued benefit asset (liability) | **34** | 13 | **(34)** | (22) |
| Valuation allowance | **(7)** | (7) | **–** | – |
| Accrued benefit asset (liability), net of valuation allowance | **$ 27** | $ 6 | **$ (34)** | $ (22) |

# Notes to Consolidated Financial Statements (continued)

## 13 Employee future benefits *(continued)*

Included in the above accrued benefit obligations and fair value of pension plan assets at year-end are the following amounts in respect of pension plans that are not fully funded:

| | 2003 | 2002 |
|---|---|---|
| Accrued benefit obligation | $ 105 | $ 87 |
| Fair value of plan assets | 57 | 46 |
| Funded status – deficit, measurement date | 48 | 41 |
| Bank contributions after measurement date | 26 | 2 |
| Funded status – deficit, at year end | $ 22 | $ 39 |

The Bank's net benefit plan expense for its defined benefit plans for the years ended December 31 are as follows:

| | *Pension benefits* | | *Other benefits* | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Service cost | $ 9 | $ 8 | $ 5 | $ 3 |
| Interest cost | 12 | 11 | 5 | 4 |
| Expected return on plan assets | (10) | (11) | – | – |
| Amortization of transitional (asset) obligation | (4) | (4) | 2 | 2 |
| Amortization of net actuarial loss | 4 | 3 | 1 | – |
| Increase in valuation allowance | – | 2 | – | – |
| Net benefit plan expense | $ 11 | $ 9 | $ 13 | $ 9 |

The expense for the Bank's defined contribution pension plan for the year was $2 million (2002 - $2 million).

The significant actuarial assumptions adopted in measuring the Bank's accrued benefit obligations are as follows (weighted-average assumptions as of December 31):

| | *Pension benefits* | | *Other benefits* | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Discount rate | 6.75% | 7.00% | 6.75% | 7.00% |
| Expected long-term rate of return on plan assets | 7.25% | 7.25% | – | – |
| Rate of compensation increase | 4.0% | 4.0% | 4.0% | 4.0% |

For measurement purposes for 2003, an 8.2% health care cost trend rate was assumed grading down to 4.6% by 2009 and assumed to remain level thereafter (2002 - 5.3% grading down to 3.9% by 2004 and assumed to remain level thereafter).

The weighted-average EARSL of the active employees under the pension plans is 15 years and 19 years under the post-retirement, non-pension arrangements.

During 2003, existing employees were given a one-time option to transfer from membership in their existing defined benefit pension plans to a new defined contribution pension plan. The effective date of the transfer was January 1, 2004. The accrued benefit obligations up to December 31, 2003 were retained in the existing defined benefit plans for those employees whose chose to switch to the new defined contribution pension plan. The new defined contribution pension plan runs concurrently with the existing defined benefit pension plans. There are no curtailment gains or losses recorded as a result of the transfer of certain employees to the new defined contribution plan.

Employees hired subsequent to October 1, 2003 were required to participate in the new defined contribution pension plan. Contributions by the Bank during 2003 into this new plan were not material.

## 13 Employee future benefits *(continued)*

*Sensitivity of assumptions*

Key weighted-average economic assumptions used in measuring the pension benefit liability, the other employee future benefits liability and related expenses are outlined in the adjoining table. The sensitivity analysis provided in the table should be used with caution as it is hypothetical and changes in each key assumption may not be linear. The sensitivities in each key variable have been calculated independently of changes in other key variables.

Actual experience may result in changes in a number of key assumptions simultaneously. Changes in one factor may result in changes in another, which could amplify or reduce certain sensitivities.

| | *Pension benefits* | | *Other benefits* | |
|---|---|---|---|---|
| | *Accrued benefit obligation* | *Benefits expense* | *Accrued benefit obligation* | *Benefits expense* |
| Expected rate of return on plan assets (%) | – | 7.25% | – | – |
| Impact of 1% increase | – | $ (2) | – | – |
| Impact of 1% decrease | – | $ 2 | – | – |
| Discount rate (%) | 6.75% | 7.00% | 6.75% | 7.00% |
| Impact of 1% increase | $ (26) | $ (2) | $ (16) | $ (2) |
| Impact of 1% decrease | $ 33 | $ 2 | $ 22 | $ 2 |
| Rate of compensation increase (%) | 4.0% | 4.0% | 4.0% | 4.0% |
| Impact of 0.25% increase | $ 4 | $ 1 | – | – |
| Impact of 0.25% decrease | $ (4) | $ (1) | – | – |
| Assumed overall health care cost trend (%) | – | – | 8.2%(1) | 5.3%(2) |
| Impact of 1% increase | – | – | $ 20 | $ 3 |
| Impact of 1% decrease | – | – | $ (15) | $ (2) |

(1) *Grading down to 4.6% in 2009.*

(2) *Grading down to 3.9% in 2004.*

## 14 Income taxes

**a** Provisions for income taxes included in the consolidated statements of income are:

| | **2003** | 2002 |
|---|---|---|
| Current income taxes: | | |
| Federal | **$ 133** | $ 121 |
| Provincial | **69** | 58 |
| | **202** | 179 |
| Future income taxes: | | |
| Federal | **(8)** | (8) |
| Provincial | **(5)** | (7) |
| | **(13)** | (15) |
| Total income taxes | **$ 189** | $ 164 |

# Notes to Consolidated Financial Statements (continued)

## 14 Income taxes *(continued)*

**b** The provisions for income taxes shown in the consolidated statements of income are different than that obtained by applying statutory tax rates to income before provision for income taxes and non-controlling interest in income of trust, for the following reasons:

| | **2003** | 2002 |
|---|---|---|
| Combined federal and provincial income tax rate | **36.5%** | 38.9% |
| Adjustments resulting from: | | |
| Adjustment for tax exempt income | **(0.3)** | (2.8) |
| Utilization of tax losses carried forward and other deductions | **0.4** | – |
| Substantively enacted tax rate changes | **(1.5)** | 0.1 |
| Additional financial institution taxes | **0.1** | 0.3 |
| Other, net | **3.5** | 2.2 |
| Effective tax rate | **38.7%** | 38.7% |

**c** The net future income tax asset reported in other assets is comprised as follows:

| | **2003** | 2002 |
|---|---|---|
| Future income tax assets: | | |
| Allowance for credit losses | **$ 90** | $ 77 |
| Other available deductions | **36** | 30 |
| Non-capital losses | **28** | 30 |
| Buildings and equipment | **9** | 6 |
| Other | **6** | 11 |
| | **169** | 154 |
| Valuation allowance | **(9)** | (8) |
| | **160** | 146 |
| Future income tax liabilities: | | |
| Leases | **(10)** | (15) |
| Intangible assets | **(8)** | (12) |
| Other | **(19)** | (3) |
| | **(37)** | (30) |
| Net future income tax asset | **$ 123** | $ 116 |

## 15 Guarantees, commitments and contingent liabilities

a *Credit-related*

In the normal course of business, the Bank enters into various off-balance sheet commitments and contingent liability contracts. The primary purpose of these contracts is to make funds available for the financing needs of customers. The Bank's policy for requiring collateral security with respect to these contracts and the types of collateral security held is generally the same as for loans made by the Bank.

Financial and performance standby letters of credit represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties and they carry the same credit risk, recourse and collateral security requirements as loans extended to customers. Documentary and commercial letters of credit are instruments issued on behalf of a customer authorizing a third party to draw drafts on the Bank up to a certain amount subject to specific terms and conditions. The Bank is at risk for any drafts drawn that are not ultimately settled by the customer, and the amounts are collateralized by the goods to which they relate. Commitments to extend credit represent unutilized portions of authorizations to extend credit in the form of loans and customers' liability under acceptances.

The credit instruments reported below represent the maximum amount of additional credit that the Bank could be obligated to extend should contracts be fully utilized.

| | **2003** | 2002 |
|---|---|---|
| Financial and performance standby letters of credit | **$ 1,421** | $ 1,244 |
| Documentary and commercial letters of credit | **421** | 434 |
| | **$ 1,842** | $ 1,678 |

The Bank is subject to limited recourse for credit losses and shortfall of yield on certain of the securitized assets. At December 31, 2003, total recourse against the Bank under securitization transactions was $18 million (2002 - $14 million).

b *Long-term lease commitments*

Future minimum commitments under long-term leases of premises are as follows:

| | |
|---|---|
| 2004 | $ 34 |
| 2005 | 30 |
| 2006 | 25 |
| 2007 | 19 |
| 2008 | 16 |
| 2009 and thereafter | 46 |
| | $ 170 |

The total rental expense charged in respect of premises for the year was $38 million (2002 - $41 million).

c *Mortgages sold with recourse*

The Bank has agreed to repurchase any mortgage purchased from it by the HSBC Mortgage Mutual Fund if any principal and interest payments due are more than 90 days in arrears. The amount of mortgages sold with recourse as at December 31, 2003 was $181 million (2002 - $160 million).

d *Litigation*

A Bank subsidiary is subject to threatened actions relating to its responsibilities as a distributor, escrow agent and custodian. Based upon information presently available, counsel for the Bank are not in a position to express an opinion as to the likely outcome. Accordingly, no provisions have been recorded in the consolidated financial statements relating to these matters.

The Bank and its subsidiaries are subject to a number of other legal proceedings arising in the normal course of their businesses. Management does not expect the outcome of any of these other proceedings, in aggregate, to have a material effect on the consolidated financial position or results of the Bank's operations.

# Notes to Consolidated Financial Statements (continued)

## 16 Fair value of financial instruments

The amounts below represent the fair values of the Bank's on-balance sheet financial instruments as at December 31. Fair value is the estimated amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act and is best evidenced by a quoted market price, if one exists. Many of the Bank's financial instruments lack an available trading market. Therefore, these instruments have been valued using present value or other valuation techniques and may not necessarily be indicative of the amounts realizable in an immediate settlement of the instruments. In addition, the calculation of estimated fair value is based on market conditions at a specific point in time and may not be reflective of future fair values.

Changes in interest rates are the main cause of changes in the fair value of the Bank's financial instruments. The majority of the Bank's financial instruments are carried at historical cost and are not adjusted to reflect increases or decreases in fair value due to market fluctuations, including those due to interest rate changes. For those financial instruments held for trading purposes, the carrying value is adjusted daily to reflect the fair value.

The following table sets out the fair values of on-balance sheet financial instruments of the Bank using the valuation methods and assumptions described below. The fair values disclosed do not reflect the value of assets and liabilities that are not considered financial instruments, such as land, buildings and equipment.

| | **2003** | | | 2002 | | |
|---|---|---|---|---|---|---|
| | *Book value* | *Fair value* | *Fair value over (under) book value* | *Book value* | *Fair value* | *Fair value over (under) book value* |
| **Assets** | | | | | | |
| Cash resources | **$ 3,629** | **$ 3,629** | **$ –** | $ 3,734 | $ 3,734 | $ – |
| Securities | **2,876** | **2,905** | **29** | 3,745 | 3,775 | 30 |
| Securities purchased under reverse repurchase agreements | **1,572** | **1,572** | **–** | 416 | 416 | – |
| Loans | **24,933** | **25,039** | **106** | 23,869 | 24,017 | 148 |
| Acceptances | **3,247** | **3,247** | **–** | 2,374 | 2,374 | – |
| Other assets | **968** | **968** | **–** | 768 | 768 | – |
| **Liabilities** | | | | | | |
| Deposits | **$ 29,339** | **$ 29,416** | **$ 77** | $ 28,372 | $ 28,457 | $ 85 |
| Acceptances | **3,247** | **3,247** | **–** | 2,374 | 2,374 | – |
| Securities sold under repurchase agreements | **30** | **30** | **–** | 28 | 28 | – |
| Other liabilities | **2,570** | **2,570** | **–** | 1,984 | 1,984 | – |
| Debentures | **504** | **532** | **28** | 528 | 563 | 35 |

The determination of fair values of financial instruments for which there are no quoted market values requires that a number of assumptions are made for which there exists a significant degree of subjectivity. The following methods and assumptions were used to estimate the fair value of these financial instruments:

- Cash resources, acceptances, securities purchased under reverse repurchase agreements, other assets, securities sold under repurchase agreements and other liabilities are assumed to approximate their carrying values, due to their short term nature.
- Investment securities are assumed to be equal to the estimated market value of securities provided in Note 2. These values are based on quoted market prices where available. If quoted market prices are not available, fair values are estimated using quoted market prices of similar securities or other valuation techniques. Trading securities have carrying values which are equal to their estimated market value.
- Floating rate loans are assumed to be equal to their book value. The fair values of loans with fixed terms are estimated using a discounted cash flow calculation at current rates for loans with similar terms and risks.

  Demand and floating rate deposits are assumed to be equal to their carrying value. The fair values of fixed rate deposits are estimated using a discounted cash flow calculation at current rates for deposits with similar terms and risks.
- The fair value of debentures is determined by reference to current market prices for debt with similar terms and risks.

## 17 Derivative instruments

In the ordinary course of business, the Bank enters into various derivative contracts such as foreign exchange contracts, interest rate swaps, forward rate agreements and financial futures contracts whose notional principal is not included in the consolidated balance sheets.

Derivatives are contracts whose value is derived from an underlying asset or an underlying reference rate or index such as interest or foreign exchange rates. The Bank uses derivatives for both trading and asset/liability management purposes.

Trading related activity includes transactions undertaken on behalf of the Bank and its customers ("Trading"). Asset/liability management derivatives are used by the Bank to manage its exposures to interest rate and foreign currency fluctuations and where appropriate the Bank may use customer related trading transactions as part of its asset/liability management ("ALM") program.

The Bank strictly adheres to its formalized risk management policies and procedures. Risk limits are determined for each portfolio of derivative instruments based on product, currency, interest rate repricing and market volatility. All limits are monitored on a daily basis.

Derivative instruments are subject to both market risk and credit risk. Market risk is the risk that the fair value of derivatives will fluctuate due to changes in interest or foreign exchange rates, and equity markets. Market risk is managed on a consolidated Bank basis.

Credit risk for derivative instruments is not equal to the notional amount of the principal as it is with assets recorded on the consolidated balance sheets. The credit risk for derivatives is principally the replacement cost of any contract with a positive market value plus an estimate for future fluctuation risk. Credit risk for derivatives is managed using the Bank's risk management policies.

**a** An analysis of the Bank's derivative portfolio and related credit exposure at December 31 is as follows:

| | 2003 | | | | 2002 | | | |
|---|---|---|---|---|---|---|---|---|
| | *Notional amount* | *Current replacement cost* | *Credit equivalent amount* | *Risk weighted balance* | *Notional amount* | *Current replacement cost* | *Credit equivalent amount* | *Risk weighted balance* |
| **Interest rate contracts** | | | | | | | | |
| Futures – exchange traded | **$ 1,224** | **$ –** | **$ –** | **$ –** | $ 346 | $ – | $ – | $ – |
| Swaps | **11,607** | **115** | **149** | **39** | 7,724 | 172 | 187 | 51 |
| Caps | **80** | **–** | **1** | **–** | 77 | – | 1 | – |
| | **12,911** | **115** | **150** | **39** | 8,147 | 172 | 188 | 51 |
| **Foreign exchange contracts** | | | | | | | | |
| Spot contracts | **188** | **1** | **1** | **–** | 257 | 1 | – | – |
| Forward contracts | **13,299** | **283** | **468** | **115** | 13,428 | 169 | 389 | 100 |
| Currency futures | **39** | **–** | **–** | **–** | 21 | – | – | – |
| Currency swaps and options | **1,390** | **35** | **52** | **19** | 966 | 6 | 17 | 5 |
| | **14,916** | **319** | **521** | **134** | 14,672 | 176 | 406 | 105 |
| **Equity contracts** | **31** | **–** | **3** | **1** | 276 | 1 | 12 | 3 |
| **Total** | **$ 27,858** | **$ 434** | **$ 674** | **$ 174** | $ 23,095 | $ 349 | $ 606 | $ 159 |
| Impact of master netting agreements | | **(19)** | **(39)** | **(8)** | | (65) | (106) | (21) |
| | | **$ 415** | **635** | **$ 166** | | $ 284 | $ 500 | $ 138 |

# Notes to Consolidated Financial Statements (continued)

## 17 Derivative instruments *(continued)*

Notional amounts are the contract amounts used to calculate the cash flows to be exchanged. They are a common measure of volume of outstanding transactions, but do not represent credit or market risk exposure.

Current replacement cost represents the estimated cost of replacing, at current market rates, all contracts with a positive value. Credit equivalent amount is the current replacement cost plus an amount for future credit exposure associated with the potential for future changes in currency and interest rates. The future credit exposure is calculated using a formula prescribed by the Superintendent in its capital adequacy guidelines.

Risk-weighted balance represents the amount based upon which the regulatory capital required to support the Bank's derivative activities is calculated. It is derived from risk weighting the credit equivalent amounts according to the creditworthiness of the counter parties using factors prescribed by the Superintendent in its capital adequacy guidelines.

b The following tables summarize the notional amounts by remaining term to maturity of the Bank's derivative portfolio at December 31, segregating derivative instruments between those entered into by the Bank for its customer and proprietary trading activities and those used to manage the risk associated with changes in interest and foreign exchange rates as part of the Bank's ALM program.

**2003**

| | *Trading* | | | | *ALM* | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | *Under 1 year* | *1 - 5 years* | *Over 5 years* | *Total trading* | *Under 1 year* | *1 - 5 years* | *Over 5 years* | *Total ALM* | *Total* |
| **Interest rate contracts** | | | | | | | | | |
| Futures – exchange traded | $ 1,174 | $ 50 | $ – | $ 1,224 | $ – | $ – | $ – | $ – | $ 1,224 |
| Swaps | 1,514 | 1,793 | 389 | 3,696 | 4,521 | 3,061 | 329 | 7,911 | 11,607 |
| Caps | 57 | 23 | – | 80 | – | – | – | – | 80 |
| | 2,745 | 1,866 | 389 | 5,000 | 4,521 | 3,061 | 329 | 7,911 | 12,911 |
| **Foreign exchange contracts** | | | | | | | | | |
| Spot contracts | 154 | – | – | 154 | 34 | – | – | 34 | 188 |
| Forward contracts | 9,098 | 881 | – | 9,979 | 2,955 | 365 | – | 3,320 | 13,299 |
| Currency futures | 39 | – | – | 39 | – | – | – | – | 39 |
| Currency swaps and options | 878 | 503 | – | 1,381 | – | – | 9 | 9 | 1,390 |
| | 10,169 | 1,384 | – | 11,553 | 2,989 | 365 | 9 | 3,363 | 14,916 |
| **Equity contracts** | – | 31 | – | 31 | – | – | – | – | 31 |
| **Total** | $ 12,914 | $ 3,281 | $ 389 | $ 16,584 | $ 7,510 | $ 3,426 | $ 338 | $ 11,274 | $ 27,858 |

## 17 Derivative instruments *(continued)*

| | 2002 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | *Trading* | | | | *ALM* | | | | |
| | *Under 1 year* | *1 - 5 years* | *Over 5 years* | *Total trading* | *Under 1 year* | *1 - 5 years* | *Over 5 years* | *Total ALM* | *Total* |
| **Interest rate contracts** | | | | | | | | | |
| Futures – exchange traded | $ 346 | $ – | $ – | $ 346 | $ – | $ – | $ – | $ – | $ 346 |
| Swaps | 2,025 | 1,511 | 632 | 4,168 | 1,684 | 1,645 | 227 | 3,556 | 7,724 |
| Caps | 57 | 20 | – | 77 | – | – | – | – | 77 |
| | 2,428 | 1,531 | 632 | 4,591 | 1,684 | 1,645 | 227 | 3,556 | 8,147 |
| **Foreign exchange contracts** | | | | | | | | | |
| Spot contracts | 198 | – | – | 198 | 59 | – | – | 59 | 257 |
| Forward contracts | 6,944 | 2,084 | – | 9,028 | 4,361 | 39 | – | 4,400 | 13,428 |
| Currency futures | 21 | – | – | 21 | – | – | – | – | 21 |
| Currency swaps and options | 720 | 232 | – | 952 | 3 | 11 | – | 14 | 966 |
| | 7,883 | 2,316 | – | 10,199 | 4,423 | 50 | – | 4,473 | 14,672 |
| **Equity contracts** | 276 | – | – | 276 | – | – | – | – | 276 |
| **Total** | $ 10,587 | $ 3,847 | $ 632 | $ 15,066 | $ 6,107 | $ 1,695 | $ 227 | $ 8,029 | $ 23,095 |

**c** The following tables summarize the fair values, as represented by the sum of the net unrealized gains and losses, accrued interest receivable and payable and premiums paid or received, of the Bank's derivative portfolio at December 31 segregating derivative instruments between trading and ALM and between those that are in a favourable or receivable position from those in an unfavourable or payable position.

Trading derivatives are marked to market on a daily basis and the net position for the trading portfolio shown in the table below has already been recognized in the financial statements. ALM interest rate derivatives are accounted for on the accrual basis and the net income or expense is recognized over the life of the derivative contract. Foreign exchange derivatives used for ALM purposes are accounted for on an accrual basis, as are the underlying assets and liabilities hedged. The ALM portfolio is used to manage the Bank's exposure to changes in interest and foreign currency rates. Consequently, the net favourable or unfavourable position in the ALM portfolio shown in the table below is approximately offset by changes in the values in the underlying hedged assets and liabilities.

# Notes to Consolidated Financial Statements (continued)

## 17 Derivative instruments *(continued)*

**2003**

| | Trading | | | ALM | | | |
|---|---|---|---|---|---|---|---|
| | *Favourable position* | *Unfavourable position* | *Net position* | *Favourable position* | *Unfavourable position* | *Net position* | *Total net* |
| **Interest rate contracts** | | | | | | | |
| Swaps | **$ 48** | **$ (45)** | **$ 3** | **$ 67** | **$ (18)** | **$ 49** | **$ 52** |
| **Foreign exchange contracts** | | | | | | | |
| Spot contracts | **1** | **–** | **1** | **–** | **–** | **–** | **1** |
| Forward contracts | **272** | **(263)** | **9** | **11** | **(95)** | **(84)** | **(75)** |
| Currency swaps and options | **35** | **(42)** | **(7)** | **–** | **(1)** | **(1)** | **(8)** |
| | **308** | **(305)** | **3** | **11** | **(96)** | **(85)** | **(82)** |
| **Equity contracts** | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| **Total** | **$ 356** | **$ (350)** | **$ 6** | **$ 78** | **$ (114)** | **$ (36)** | **$ (30)** |

2002

| | Trading | | | ALM | | | |
|---|---|---|---|---|---|---|---|
| | *Favourable position* | *Unfavourable position* | *Net position* | *Favourable position* | *Unfavourable position* | *Net position* | *Total net* |
| **Interest rate contracts** | | | | | | | |
| Swaps | $ 80 | $ (80) | $ – | $ 92 | $ (20) | $ 72 | $ 72 |
| **Foreign exchange contracts** | | | | | | | |
| Spot contracts | – | – | – | 1 | – | 1 | 1 |
| Forward contracts | 131 | (126) | 5 | 38 | (10) | 28 | 33 |
| Currency swaps and options | 6 | (7) | (1) | – | (2) | (2) | (3) |
| | 137 | (133) | 4 | 39 | (12) | 27 | 31 |
| **Equity contracts** | 1 | – | 1 | – | – | – | 1 |
| **Total** | $ 218 | $ (213) | $ 5 | $ 131 | $ (32) | $ 99 | $ 104 |

Fair values of derivative instruments are determined using quoted market prices.

## 18 Interest rate sensitivity position

The following table provides an analysis of the Bank's interest rate sensitivity position at December 31 based on contractual repricing dates of assets and liabilities:

| | 2003 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *Within 3 months* | *3 to 6 months* | *6 to 12 months* | *Effective interest rate (%)* | *1 to 5 years* | *Effective interest rate (%)* | *Greater than 5 years* | *Effective interest rate (%)* | *Non-interest sensitive* | *Total* |
| Cash resources | $ 3,203 | $ 65 | $ 104 | 1.6 | $ 1 | 3.9 | $ – | – | $ 256 | $ 3,629 |
| Securities | 1,349 | 649 | 548 | 3.1 | 243 | 5.1 | 15 | 4.4 | 72 | 2,876 |
| Securities purchased under reverse repurchase agreements | 1,572 | – | – | 2.6 | – | – | – | – | – | 1,572 |
| Loans | 14,164 | 945 | 1,755 | 4.5 | 8,072 | 4.5 | 107 | 6.6 | (110) | 24,933 |
| Acceptances | – | – | – | – | – | – | – | – | 3,247 | 3,247 |
| Other assets | 170 | – | – | 5.3 | – | – | – | – | 1,082 | 1,252 |
| Total assets | 20,458 | 1,659 | 2,407 | – | 8,316 | – | 122 | – | 4,547 | 37,509 |
| Deposits | 16,805 | 2,759 | 3,000 | 2.0 | 2,433 | 3.8 | – | – | 4,342 | 29,339 |
| Securities sold under repurchase agreements | 30 | – | – | 2.6 | – | – | – | – | – | 30 |
| Acceptances | – | – | – | – | – | – | – | – | 3,247 | 3,247 |
| Other liabilities | 734 | – | – | 4.2 | – | – | – | – | 1,606 | 2,340 |
| Non-controlling interest in trust and subsidiary | – | – | – | – | – | – | 200 | 7.8 | 30 | 230 |
| Debentures | 40 | – | 110 | 5.5 | 354 | 7.4 | – | – | – | 504 |
| Shareholders' equity | – | – | – | – | 125 | 6.3 | – | – | 1,694 | 1,819 |
| Total liabilities & shareholders' equity | 17,609 | 2,759 | 3,110 | – | 2,912 | – | 200 | – | 10,919 | 37,509 |
| On balance sheet gap | 2,849 | (1,100) | (703) | – | 5,404 | – | (78) | – | (6,372) | – |
| Off balance sheet positions | 1,072 | 227 | (1,029) | – | (459) | – | 189 | – | – | – |
| Total interest rate gap | $ 3,921 | $ (873) | $(1,732) | – | $ 4,945 | – | $ 111 | – | $(6,372) | $ – |

# Notes to Consolidated Financial Statements (continued)

## 18 Interest rate sensitivity position *(continued)*

| | 2002 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *Within 3 months* | *3 to 6 months* | *6 to 12 months* | *Effective interest rate (%)* | *1 to 5 years* | *Effective interest rate (%)* | *Greater than 5 years* | *Effective interest rate (%)* | *Non-interest sensitive* | *Total* |
| Cash resources | $ 3,396 | $ 79 | $ 5 | 1.6 | $ – | – | $ – | – | $ 254 | $ 3,734 |
| Securities | 1,749 | 717 | 432 | 3.0 | 522 | 5.6 | 14 | 4.6 | 311 | 3,745 |
| Securities purchased under reverse repurchase agreements | 416 | – | – | 2.7 | – | – | – | – | – | 416 |
| Loans | 14,318 | 1,085 | 1,866 | 4.4 | 6,546 | 5.6 | 139 | 5.4 | (85) | 23,869 |
| Acceptances | – | – | – | – | – | – | – | – | 2,374 | 2,374 |
| Other assets | 139 | – | – | 5.3 | – | – | – | – | 912 | 1,051 |
| Total assets | 20,018 | 1,881 | 2,303 | – | 7,068 | – | 153 | – | 3,766 | 35,189 |
| Deposits | 15,891 | 2,609 | 4,272 | 1.8 | 1,654 | 4.4 | 1 | 4.4 | 3,945 | 28,372 |
| Securities sold under repurchase agreements | 28 | – | – | 2.7 | – | – | – | – | – | 28 |
| Acceptances | – | – | – | – | – | – | – | – | 2,374 | 2,374 |
| Other liabilities | 207 | – | – | 1.0 | – | – | – | – | 1,777 | 1,984 |
| Non-controlling interest in trust and subsidiary | – | – | – | – | – | – | 200 | 7.8 | 30 | 230 |
| Debentures | 40 | – | – | 3.3 | 488 | 7.1 | – | – | – | 528 |
| Shareholders' equity | – | – | – | – | 125 | 6.3 | – | – | 1,548 | 1,673 |
| Total liabilities & shareholders' equity | 16,166 | 2,609 | 4,272 | – | 2,267 | – | 201 | – | 9,674 | 35,189 |
| On balance sheet gap | 3,852 | (728) | (1,969) | – | 4,801 | – | (48) | – | (5,908) | – |
| Off balance sheet positions | (978) | 222 | (222) | – | 790 | – | 188 | – | – | – |
| Total interest rate gap | $ 2,874 | $ (506) | $(2,191) | – | $ 5,591 | – | $ 140 | – | $(5,908) | $ – |

## 19 Segmented information

a *Customer groups:*

The Bank reports and manages its operations according to the customer group definitions used by Group. For 2003, the Bank has combined "Wholesale Banking" and "Treasury and Markets" into one customer group called "Corporate, Investment Banking and Markets". The comparative information has been reclassified to give effect to this new structure. "Commercial Financial Services" has been renamed "Commercial Banking".

Effective January 1, 2003, the Bank implemented a funds transfer pricing system which shifts structural interest rate risk from the business units to the Treasury department. Refinements to the Bank's funding and cost allocations have also been implemented. Accordingly, the comparative results of the customer groups have been restated.

## 19 Segmented information *(continued)*

A description of each segment is as follows:

***Personal Financial Services*** provides services to individuals by offering a comprehensive range of financial products and services which include retail banking, asset management, full service and discount brokerage, direct sale home, automobile and travel insurance, and trust and advisory services.

***Commercial Banking*** meets the needs of Canadian commercial and corporate clients by offering commercial and corporate banking, asset management, mergers and acquisition ("M&A") advisory, merchant banking, treasury, and trade finance.

***Corporate, Investment Banking and Markets*** provides a comprehensive range of financial services to an international group of HSBC's large multinational clients as well as client sales, service and distribution, balance sheet management, and proprietary trading. The Bank's focus is on entities that have a need for global value added products through M&A advisory, structured lending and trade services by offering the following: corporate banking; asset management; M&A advisory; treasury; and trade finance.

***Other*** includes the effect of consolidation adjustments and unallocated revenues and expenses.

The accounting policies of the segments are generally consistent with those followed in the preparation of the consolidated financial statements as disclosed in note 1.

| | **Year ended December 31, 2003** | | | | |
|---|---|---|---|---|---|
| | *Personal financial services* | *Commercial banking* | *Corporate, investment banking and markets* | *Other* | *Total* |
| Net interest income | **$ 317** | **$ 408** | **$ 142** | **$ –** | **$ 867** |
| Provision for credit losses | **(10)** | **(47)** | **(4)** | **–** | **(61)** |
| Other income | **242** | **127** | **94** | **–** | **463** |
| Non-interest expenses | **(412)** | **(248)** | **(49)** | **(55)** | **(764)** |
| Net income before the under noted: | **137** | **240** | **183** | **(55)** | **505** |
| Provision for income taxes | **(51)** | **(90)** | **(69)** | **21** | **(189)** |
| Non-controlling interest in income of trust | **(5)** | **(8)** | **(3)** | **–** | **(16)** |
| Net income | **$ 81** | **$ 142** | **$ 111** | **$ (34)** | **$ 300** |
| Average assets | **$ 13,600** | **$ 12,678** | **$ 10,357** | **$ –** | **$ 36,635** |

| | Year ended December 31, 2002 (restated) | | | | |
|---|---|---|---|---|---|
| | *Personal financial services* | *Commercial banking* | *Corporate, investment banking and markets* | *Other* | *Total* |
| Net interest income | $ 323 | $ 399 | $ 134 | $ – | $ 856 |
| Provision for credit losses | (9) | (48) | (70) | – | (127) |
| Other income | 204 | 134 | 103 | – | 441 |
| Non-interest expenses | (365) | (219) | (94) | (52) | (730) |
| Net income before the under noted: | 153 | 266 | 73 | (52) | 440 |
| Provision for income taxes | (57) | (100) | (28) | 21 | (164) |
| Non-controlling interest in income of trust | (5) | (8) | (3) | – | (16) |
| Net income | $ 91 | $ 158 | $ 42 | $ (31) | $ 260 |
| Average assets | $ 11,757 | $ 13,036 | $ 10,034 | $ – | $ 34,827 |

# Notes to Consolidated Financial Statements (continued)

## 19 Segmented information *(continued)*

b *Geographic*:

| | 2003 | | | |
|---|---|---|---|---|
| | *Assets* | | *Liabilities* | |
| | *Amount* | *Percent* | *Amount* | *Percent* |
| Canada | **$ 34,464** | **91.9** | **$ 31,779** | **89.0** |
| United States | **2,060** | **5.5** | **1,131** | **3.2** |
| Hong Kong SAR | **128** | **0.3** | **1,196** | **3.3** |
| Other | **857** | **2.3** | **1,584** | **4.5** |
| Total | **$ 37,509** | **100.0** | **$ 35,690** | **100.0** |

| | 2002 | | | |
|---|---|---|---|---|
| | *Assets* | | *Liabilities* | |
| | *Amount* | *Percent* | *Amount* | *Percent* |
| Canada | $ 31,988 | 90.9 | $ 28,673 | 85.6 |
| United States | 2,956 | 8.4 | 1,172 | 3.5 |
| Hong Kong SAR | 105 | 0.3 | 1,826 | 5.4 |
| Other | 140 | 0.4 | 1,845 | 5.5 |
| Total | $ 35,189 | 100.0 | $ 33,516 | 100.0 |

Assets are allocated on the basis of the location of ultimate risk. Liabilities are allocated on the basis of the residence status of the bearer of the deposit, acceptances or other liability.

## 20 Business acquisitions

*2002 acquisitions*

On October 31, 2002, the Bank acquired all of the issued and outstanding shares of Merrill Lynch HSBC Canada Inc. ("MLHSBC") at a valuation of $15 million, as determined by an independent third party, satisfied by the issuance of 15 million common shares at $1 per share. The acquisition of MLHSBC was a related party transaction as ownership was transferred within the HSBC Group. Accordingly, the acquisition was measured at the Group's carrying amount, which was pushed down to MLHSBC, effective July 1, 2002, the date that the HSBC Group acquired its controlling interest in MLHSBC.

The acquisition was accounted for as an exchange of ownership interests under common control using the Group's carrying amounts of the net assets acquired, with the difference allocated to shareholders' equity as follows:

| | |
|---|---|
| Tangible assets | $ 326 |
| Intangible assets | 11 |
| Liabilities | (341) |
| Carrying amount – deficit | 4 |
| Common shares issued | 15 |
| Reduction in shareholders' equity | $ 19 |

In accordance with Canadian GAAP, the results of MLHSBC have been consolidated with those of the Bank subsequent to July 1, 2002. In 2003, Merrill Lynch HSBC Canada Inc. was renamed HSBC InvestDirect Inc.

## 21 Related party transactions

The Bank pays fees to Group companies with respect to guarantees of deposit liabilities, and administrative and technical services provided to the Bank. The total fees for the year amounted to $84 million (2002 - $70 million).

Group companies hold certain debentures and preferred shares (notes 9 and 10).

The Bank has an agreement with a Group company to provide a standby borrowing facility of up to US$300 million to the Bank at market rates and conditions. Funds have not been drawn from the facility since entering into the agreement.

In addition to the above related party transactions, the Bank has transactions of a routine nature with Group companies, none of which are material to these financial statements.

*2002*

Effective December 9, 2002, HSBC USA Inc., a subsidiary of the Parent, purchased certain assets and assumed certain liabilities of the Bank's branches in Seattle, Washington and Portland, Oregon. Subsequent to December 9, 2002 HSBC USA Inc. assumed the daily operations of these two branches. The sale was accounted for as an exchange of ownership interests under common control using the carrying amounts, as supported by an independent third party valuation, of the net assets sold:

| | | |
|---|---|---|
| Assets sold | $ | 416 |
| Liabilities relieved | | 395 |
| | | 21 |
| Premium | | 1 |
| Total cash consideration received | $ | 22 |

As this was a related party transaction, the premium received, net of related income taxes, was recorded in retained earnings.

The result of operations of the two branches is not sufficiently material to the Bank's consolidated statement of income to warrant separate disclosure.

The Bank's wholly owned principal operating subsidiaries are as follows:

| *Principal subsidiaries* | *Principal office address* | *Book value of voting shares* |
|---|---|---|
| HSBC Asset Management (Canada) Limited | Vancouver, British Columbia | $ 5 |
| HSBC Canadian Direct Insurance Incorporated | New Westminster, British Columbia | 35 |
| HSBC Capital (Canada) Inc. | Vancouver, British Columbia | 8 |
| HSBC InvestDirect Inc.(1) | Toronto, Ontario | 19 |
| HSBC Investment Funds (Canada) Inc. | Vancouver, British Columbia | 1 |
| HSBC Loan Corporation (Canada) | Vancouver, British Columbia | 2 |
| HSBC Mortgage Corporation (Canada) | Vancouver, British Columbia | 227 |
| HSBC Securities (Canada) Inc.(1) | Toronto, Ontario | 236 |
| HSBC Trust Company (Canada) | Edmonton, Alberta | 26 |

(1) *On January 1, 2004, HSBC InvestDirect Inc. and HSBC Securities (Canada) Inc. were amalgamated and continued under the name HSBC Securities (Canada) Inc.*

## The HSBC Group: International Network*

Services are provided by over 9,500 offices in 79 countries and territories:

| Europe | *Offices* |
|---|---|
| Armenia | 2 |
| Azerbaijan | 1 |
| Belgium | 6 |
| Channel Islands | 34 |
| Cyprus | 144 |
| Czech Republic | 4 |
| France | 804 |
| Germany | 11 |
| Greece | 70 |
| Hungary | 3 |
| Ireland | 14 |
| Isle of Man | 6 |
| Italy | 5 |
| Luxembourg | 8 |
| Malta | 64 |
| Monaco | 2 |
| Netherlands | 1 |
| Poland | 5 |
| Russia | 3 |
| Spain | 4 |
| Sweden | 3 |
| Switzerland | 15 |
| Turkey | 160 |
| United Kingdom | 1,908 |

| Asia-Pacific | *Offices* |
|---|---|
| Australia | 39 |
| Bangladesh | 6 |
| Brunei Darussalam | 13 |
| China | 30 |
| Cook Islands | 1 |
| Hong Kong Special Administrative Region | 381 |
| India | 41 |
| Indonesia | 13 |
| Japan | 6 |
| Kazakhstan | 1 |
| Korea, Republic of | 12 |
| Macau Special Administrative Region | 5 |
| Malaysia | 42 |
| Maldives | 1 |
| New Zealand | 9 |
| Pakistan | 2 |
| Philippines | 24 |
| Singapore | 26 |
| Sri Lanka | 10 |
| Taiwan | 19 |
| Thailand | 2 |
| Vietnam | 2 |

| Americas | *Offices* |
|---|---|
| Argentina | 196 |
| Bahamas | 5 |
| Bermuda | 9 |
| Brazil | 1,470 |
| British Virgin Islands | 3 |
| Canada | 282 |
| Cayman Islands | 6 |
| Chile | 2 |
| Mexico | 1,387 |
| Panama | 16 |
| United States of America | 2,266 |
| Uruguay | 6 |
| Venezuela | 1 |

| Middle East and Africa | *Offices* |
|---|---|
| Algeria | 1 |
| Angola | 1 |
| Bahrain | 8 |
| Côte d'Ivoire | 1 |
| Egypt | 16 |
| Ghana | 1 |
| Iran | 1 |
| Israel | 4 |
| Jordan | 2 |
| Lebanon | 6 |
| Libya | 1 |
| Mauritius | 14 |
| Morocco | 1 |
| Oman | 5 |
| Palestinian Autonomous Area | 1 |
| Qatar | 4 |
| Saudi Arabia | 75 |
| South Africa | 10 |
| Uganda | 1 |
| United Arab Emirates | 16 |

*Associated companies are included in the network of offices.*

## HSBC Bank Canada Branches and Subsidiaries*

**British Columbia**
Abbotsford
Burnaby (3)
Campbell River
Chilliwack
Coquitlam (2)
Cranbrook
Kamloops
Kelowna (2)
Langley
Maple Ridge
Nanaimo (2)
New Westminster
North Vancouver (2)
Penticton
Port Coquitlam
Prince George
Richmond (4)
Surrey (3)
Vancouver (16)
Vernon
Victoria (3)
West Vancouver
White Rock

**Alberta**
Calgary (5)
Edmonton (4)
Lethbridge
Medicine Hat
Red Deer

**Saskatchewan**
Regina
Saskatoon

**Manitoba**
Winnipeg

**Ontario**
Barrie
Brampton
Etobicoke
Hamilton
Kanata
Kingston
Kitchener
London
Markham (3)
Mississauga (3)
Oakville
Ottawa
Richmond Hill (2)
St. Catharines
Sault Ste. Marie
Scarborough (3)
Thunder Bay
Timmins
Toronto (9)
Unionville
Vaughan
Whitby
Willowdale
Windsor

**Québec**
Brossard
Chicoutimi
Laval
Longueuil
Montréal (4)
Pointe-Claire
Québec City
Saint-Léonard
Sherbrooke
Trois-Rivières

**New Brunswick**
Fredericton
Saint John

**Nova Scotia**
Halifax

**Newfoundland**
St. John's

**SUBSIDIARIES**

**HSBC Asset Management (Canada) Limited**
1 (888) 390-3333
hsbc.ca/assetmanagement

**HSBC Canadian Direct Insurance Incorporated**
1 (888) 225-5234
canadiandirect.com

**HSBC Capital (Canada) Inc.**
(604) 631-8088
(416) 864-2897
hsbc.ca/capital

**HSBC InvestDirect, a division of HSBC Securities (Canada) Inc.**
investdirect.hsbc.ca

**HSBC Investment Funds (Canada) Inc.**
1 (800) 830-8888
hsbc.ca/funds

**HSBC Securities (Canada) Inc.**
1 (800) 332-1182
hsbc.ca/securities

**HSBC Trust Company (Canada)**
1 (888) 887-3388
hsbc.ca/trust

For more information, or to find the HSBC Bank Canada branch nearest you, call 1 (800) 889-4522 or visit our website: hsbc.ca

**All information on this page and the inside back cover is at March 1, 2004.*

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